

**COMMONWEALTH OF PUERTO RICO**

Comprehensive Annual Financial Report

Year ended June 30, 2008

(With Independent Auditors' Report Thereon)

# **COMPREHENSIVE ANNUAL FINANCIAL REPORT**

*Fiscal Year Ended June 30, 2008*



***Commonwealth of Puerto Rico***

***Honorable Luis G. Fortuño Burset***  
***Governor***

*Prepared by:*

***Puerto Rico Department of the Treasury***

***Juan C. Puig Morales***  
***Secretary of the Treasury***

***Luis A. Báez Black, CPA***  
***Assistant Secretary of Central Accounting***

*This document is available on the Puerto Rico Department of the Treasury homepage  
On the World Wide Web: <http://www.hacienda.gobierno.pr>*

**COMMONWEALTH OF PUERTO RICO**

Comprehensive Annual Financial Report

Year ended June 30, 2008

**Table of Contents**

	<b>Page</b>
<b>Introductory Section (Unaudited)</b>	
Letter of Transmittal	I
Principal Officials	XV
Organization Chart	XVI
<b>Financial Section</b>	
Independent Auditors' Report	1
Management's Discussion and Analysis (Unaudited)	3
Basic Financial Statements:	
Government-wide Financial Statements:	
Statement of Net Assets (Deficit)	20
Statement of Activities	22
Fund Financial Statements:	
Balance Sheet – Governmental Funds	23
Reconciliation of the Balance Sheet to the Statement of Net Assets (Deficit) – Governmental Funds	25
Statement of Revenue, Expenditures, and Changes in Fund Balances (Deficit) – Governmental Funds	26
Reconciliation of the Statement of Revenue, Expenditures, and Changes in Fund Balances (Deficit) to the Statement of Activities – Governmental Funds	27
Statement of Revenue and Expenditures – Budget and Actual – Budget Basis – General Fund	28
Statement of Net Assets (Deficit) – Proprietary Funds	29
Statement of Revenue, Expenses, and Changes in Net Assets (Deficit) – Proprietary Funds	30
Statement of Cash Flows – Proprietary Funds	31

**COMMONWEALTH OF PUERTO RICO**

**Comprehensive Annual Financial Report**

**Year ended June 30, 2008**

	<b>Page</b>
Statement of Fiduciary Net Assets	32
Statement of Changes in Fiduciary Net Assets – Pension Trust Funds	33
Combining Statement of Net Assets (Deficit) – Major Component Units	34
Combining Statement of Activities – Major Component Units	36
Notes to Basic Financial Statements	37
Required Supplementary Information:	
Schedule of Funding Progress – Retirement Systems	165
Schedule of Funding Progress – Postemployment Healthcare Benefits	166
<b>Combining, Individual Fund Financial Statements and Schedules</b>	
General Fund:	
Supplemental Schedule of Expenditures by Agency – Budget and Actual – Statutory Basis – General Fund	168
Nonmajor Governmental Funds:	
Combining Balance Sheet – Nonmajor Governmental Funds	172
Combining Statement of Revenue, Expenditures, and Changes in Fund Balances – Nonmajor Governmental Funds	173
Nonmajor Proprietary Funds:	
Combining Statement of Net Assets – Nonmajor Proprietary Funds	175
Combining Statement of Revenue, Expenses, and Changes in Net Assets – Nonmajor Proprietary Funds	176
Combining Statement of Cash Flows – Nonmajor Proprietary Funds	177
Fiduciary Funds:	
Combining Statement of Fiduciary Net Assets – Pension Trust Funds	179
Combining Statement of Changes in Fiduciary Net Assets – Pension Trust Funds	180
Combining Statement of Changes in Assets and Liabilities – Agency Fund	181



**COMMONWEALTH OF PUERTO RICO**

**Comprehensive Annual Financial Report**

**Year ended June 30, 2008**

	<b>Page</b>
Nonmajor Component Units:	
Nonmajor Discretely Presented Component Units – Statement of Net Assets (Deficit)	183
Nonmajor Discretely Presented Component Units – Statement of Activities	190
<b>Statistical Section (Unaudited)</b>	
Changes in Net Assets (Deficit) for the Last Seven Fiscal Years	192
Net Assets (Deficit) by Component for the Last Seven Fiscal Years	193
Changes in Fund Balances (Deficit) of Governmental Funds All Governmental Fund Types for the Last Ten Fiscal Years	194
Fund Balances (Deficit) of Governmental Funds for the Last Seven Fiscal Years	195
General Fund Net Revenue for the Last Ten Fiscal Years	196
Legal Debt Margin Information for the Last Ten Fiscal Years	197
Ratio of Annual Debt Service for General Bonded Debt to Total General Expenditures for the Last Ten Fiscal Years	198
Demographic and Economic Statistics for the Last Ten Years	199
Average Employment by Sector for the Last Ten Fiscal Years	200
Tourism Indicators for the Last Ten Fiscal Years	201
Operating Indicators by Function for the Last Ten Fiscal Years	202

## **INTRODUCTORY SECTION**



JUAN CARLOS PUIG  
SECRETARY OF THE TREASURY

August 12, 2009

The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico:

It is a pleasure to submit, for your information, the Comprehensive Annual Financial Report (CAFR) of the Commonwealth of Puerto Rico (the Commonwealth) as of and for the fiscal year ended June 30, 2008. This report, presented in three sections, Introductory, Financial, and Statistical, is the primary means of reporting the Commonwealth's financial activities.

The introductory section, which is not audited, includes this letter of transmittal, general information about the Commonwealth, a list of the Commonwealth's principal elected and appointed officials at the date of this letter, and an organizational chart. The financial section contains the independent auditors' report, management's discussion and analysis (MD&A), and the basic financial statements as listed in the table of contents. The financial section also includes the notes to the basic financial statements, required supplementary information, and other supplementary information. The statistical section, which is not audited, includes selected financial and demographic information, generally presented on a multiyear basis.

#### **Profile of the Commonwealth**

The Puerto Rico Department of the Treasury is responsible for the preparation of this report. The responsibility for the accuracy of presented data and the completeness and fairness of the presentation, including all of the disclosures, rests on the Commonwealth's management. To the best of our knowledge and belief, the following data, as presented, is accurate in all material respects and is presented in a manner designed to set forth the financial position and the results of operations of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the Commonwealth as of and for the year ended June 30, 2008 and the respective changes in financial position and cash flows, where applicable, thereof and the respective budgetary comparison for the general fund for the year then ended in conformity with U.S. generally accepted accounting principles. We have included all the necessary disclosures to enable the reader to gain a thorough understanding of the Commonwealth's activities.

The financial reporting entity includes all funds of the Commonwealth, which comprises the primary government, as well as all its component units. In accordance with Governmental Accounting Standards Board's Statement No. 14, *The Financial Reporting Entity*, as amended by Statement No. 39, *Determining Whether Certain Organizations are Component Units*, the Commonwealth's financial reporting entity includes 49 component units: 6 are blended component units including 3 fiduciary component units, 8 major discretely presented component units, and 35 nonmajor discretely presented component units. Component units are legally separate entities for which the primary government is financially accountable, or other organizations; the nature and significance of whose relationship with the Commonwealth are such that exclusion would cause the Commonwealth's basic financial statements to be misleading and incomplete. Blended component units, although legally separate entities, are, in substance, part of the primary government's operations and are included as part of the primary government. Discretely presented component units, both major and nonmajor, are reported in a separate column in the government-wide financial statements to emphasize that they are not part of the primary government and to differentiate their financial position and results of operations from those of the primary government.

The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page II

Generally, each component unit issues audited financial statements, which can be obtained from the component unit's administrative offices. The basic financial statements included in the financial section of this CAFR provide descriptions of the operations of each of the following component units of the Commonwealth:

***Blended Component Units***

Public Buildings Authority  
Puerto Rico Maritime Shipping Authority  
The Children's Trust

***Discretely Presented Component Units***

Agricultural Services and Development Administration  
Automobile Accidents Compensations Administration  
Cardiovascular Center Corporation of Puerto Rico and the Caribbean  
Culebra Conservation and Development Authority  
Economic Development Bank for Puerto Rico  
Employment and Training Enterprises Corporation  
Farm Insurance Corporation of Puerto Rico  
Fine Arts Center Corporation  
Governing Board of the 9-1-1 Service  
Government Development Bank for Puerto Rico  
Institute of Puerto Rican Culture  
Institutional Trust of the National Guard of Puerto Rico  
Land Authority of Puerto Rico  
National Parks Company of Puerto Rico  
Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives  
Puerto Rico Aqueduct and Sewer Authority  
Puerto Rico Conservatory of Music Corporation  
Puerto Rico Convention Center District Authority  
Puerto Rico Council on Higher Education  
Puerto Rico Electric Power Authority  
Puerto Rico Government Investment Trust Fund  
Puerto Rico Health Insurance Administration  
Puerto Rico Highways and Transportation Authority  
Puerto Rico Industrial Development Company  
Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority  
Puerto Rico Infrastructure Financing Authority  
Puerto Rico Land Administration  
Puerto Rico Maritime Transportation Authority  
Puerto Rico Medical Services Administration  
Puerto Rico Metropolitan Bus Authority  
Puerto Rico Municipal Finance Agency  
Puerto Rico Ports Authority  
Puerto Rico Public Broadcasting Corporation

The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page III

Puerto Rico Sales Tax Financing Corporation  
Puerto Rico School of Plastic Arts  
Puerto Rico Solid Waste Authority  
Puerto Rico Telephone Authority  
Puerto Rico Tourism Company  
Puerto Rico Trade and Export Company  
Right to Employment Administration  
Special Communities Perpetual Trust  
State Insurance Fund Corporation  
University of Puerto Rico

***Fiduciary Component Units***

Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities  
Puerto Rico Judiciary Retirement System  
Puerto Rico System of Annuities and Pensions for Teachers

**Independent Auditors**

Commonwealth statutes require an annual audit by independent certified public accountants. The firm of KPMG LLP was selected by the Commonwealth to perform the audit of the basic financial statements in accordance with auditing standards generally accepted in the United States of America for the fiscal year 2007 – 2008. The goal of the independent audit was to provide reasonable assurance that the financial statements of the Commonwealth for the fiscal year ended June 30, 2008 are fairly stated in accordance with U.S. generally accepted accounting principles. The independent auditors' report on the basic financial statements is included in the financial section of this report.

**Internal Controls**

The management of the Commonwealth is responsible for establishing and maintaining internal controls to ensure that assets of the Commonwealth are protected from loss, theft, or misuse, and that adequate accounting data is compiled for the preparation of financial statements in conformity with U.S. generally accepted accounting principles. The internal controls are designed to provide reasonable, but not absolute, assurance that these objectives are met. The concept of reasonable assurance recognizes that: (1) the cost of a control should not exceed the benefits likely to be derived, and (2) the valuation of costs and benefits requires estimates and judgments by management.

As a recipient of federal assistance, the Commonwealth is also responsible for ensuring that internal controls are in place to ensure that documents and processes are in compliance with applicable laws and regulations related to such federal financial assistance programs.

Certain departments, agencies, and political subdivisions are subject to the requirements of the U.S. Office of Management and Budget Circular A-133. As a result, these entities are audited for compliance with the requirements of the federal financial assistance programs. These audits are performed at the department or agency level. The Commonwealth has provided for the possible cost disallowance that may arise from these audits, as well as from other audits that may be performed by federal grantors.



The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page IV

### **Budget and Fiscal Policy**

The fiscal year of the Commonwealth begins each July 1. The Governor is constitutionally required to submit to the Legislature an annual balanced budget of operating expenses and capital improvements of the central government and its public corporations for the ensuing fiscal year.

The annual budget is prepared by the Puerto Rico Office of Management and Budget (OMB), working with the Puerto Rico Planning Board, the Puerto Rico Department of the Treasury, and other government offices and agencies. Section 7 of Article 6 of the Constitution provides that *“The appropriations made for any fiscal year shall not exceed the total revenue, including available surplus, estimated for the said fiscal year unless the imposition of taxes sufficient to cover the said appropriations is provided by law.”*

The Commonwealth’s amended budgeted expenditures for fiscal year 2008 of \$8.7 billion exceeded projected revenues of \$8.5 billion by approximately \$0.2 billion. The Commonwealth expected to cover this budget deficit through the implementation of additional expenditure reducing measures, a possible increase in tax revenues resulting from the reduction of the uncertainty surrounding the government’s fiscal crisis, and cash management mechanisms. The possible increase in tax revenues was tempered by the adverse economic impact resulting from increases in the price of oil and the implementation of the sales and use tax.

The Commonwealth maintains extensive budgetary controls. The objective of these controls is to ensure compliance with legal provisions embodied in the annual appropriated budget approved by the Legislature. Activities of the general fund are included in the annual appropriated budget. Budgetary control resides at the department level. The Commonwealth also maintains an encumbrance accounting system as one method of maintaining budgetary control.

The annual budget, which is developed using elements of program budgeting, includes an estimate of revenue and other resources for the ensuing fiscal year under laws existing at the time the budget is submitted and legislative measures proposed by the Governor and submitted with the proposed budget, as well as the Governor’s recommendations as to appropriations that in his judgment are necessary, convenient, and in conformity with the four-year investment plan prepared by the Puerto Rico Planning Board.

The Legislature may amend the budget submitted by the Governor, but may not increase items that would cause a deficit without imposing additional taxes to cover such deficit. Once approved by the Legislature, the budget is referred to the Governor, who may decrease or eliminate any item, but may not increase or insert new items in the budget. The Governor may also veto the budget in its entirety and return it to the Legislature with his objections. The Legislature, by a two-third majority in each house, may override the Governor’s veto. If a budget is not adopted prior to the commencement of the fiscal year, the budget for such fiscal year shall be the annual budget of the preceding fiscal year as originally approved by the Legislature and the Governor, it is automatically renewed for the ensuing fiscal year until a new budget is approved by the Legislature and the Governor. This allows the Commonwealth to continue to pay operating and other expenses until a new budget is approved.

### **Governmental Activities**

General governmental activities of the Commonwealth are accounted for in four governmental funds. These funds are: general, special revenue, debt service, and capital project. The general fund is the primary

The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page V

operating fund of the Commonwealth. The general fund is used to account for resources traditionally associated with government, which are not required legally or by sound financial management to be accounted for in another fund. Included are transactions for services such as general government, public safety, health, public housing and welfare, education, and economic development. Other major funds are the debt service fund, which accounts for the accumulation of resources predominantly for, and the payment of, the Commonwealth general long-term bonds' principal, interest, and related costs; the capital projects fund and the Public Buildings Authority capital projects fund, which accounts for the financial resources used for the acquisition and construction of major capital facilities; and The Children's Trust special revenue fund, which accounts for the moneys received by the Commonwealth from a global settlement agreement dated November 23, 1998 between certain tobacco companies and certain states, territories, and other jurisdictions of the United States of America, including the Commonwealth. The bond proceeds received by this fund are used to carry out projects aimed at promoting the well being of children and youth of Puerto Rico. Nonmajor governmental funds are combined in a single column in the governmental fund financial statements, and individually identified in the supplementary combining nonmajor governmental funds' financial statements of this report.

### **Business-Type Activities**

Proprietary funds are used to account for operations that are financed and operated in a manner similar to private business enterprises, where the intent of the government is that the costs of providing goods or services to the general public on a continuing basis be financed or recovered primarily through user charges or where the government has decided that periodic determination of net income is appropriate for accountability purposes.

The Commonwealth's proprietary operations comprise the following activities: the Unemployment Insurance Fund and the Lottery of Puerto Rico and the Additional Lottery System (the Lotteries Fund) are both major funds. The Puerto Rico Water Pollution Control Revolving Fund, the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund, the Disability Insurance Fund, and the Drivers' Insurance Fund are all nonmajor proprietary funds combined in a single column in the proprietary fund financial statements, and individually identified in the supplementary combining nonmajor proprietary funds' financial statements of this report.

### **Fiduciary Operations**

Fiduciary funds are used to account for assets held by the Commonwealth in a trustee capacity or as an agent for individuals, private organizations, and other governmental units. These include the pension trust and agency funds. Pension trust funds are established through trust agreements specifying how the fund will operate. Agency funds are custodial in nature and do not report fund balances. The pension trust funds include the Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities, the Puerto Rico Judiciary Retirement System, and the Puerto Rico System of Annuities and Pensions for Teachers.

Agency funds consist of the Special Deposits Fund. This agency fund includes deposits under the custody of the Courts of Justice for alimony payments and deposits under the custody of the Commissioner of Insurance of the Commonwealth for escheated property, and for insurance companies under bankruptcy.

The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page VI

### **Cash Management Policies and Practices**

The Commonwealth maintains a cash pool for its cash and cash equivalents. The balance in the pooled cash accounts is available to meet current operating requirements and any excess is invested in various interest-bearing accounts in the Government Development Bank for Puerto Rico (GDB), a discretely presented component unit. In addition, the Puerto Rico Government Investment Trust Fund (PRGITF) was created by the Commonwealth pursuant to Act No. 176 of August 11, 1995, and began operations on December 4, 1995. PRGITF is a no-load diversified collective investment trust that was created for the purpose of providing eligible investors with a convenient and economical way to invest in a professionally managed money market portfolio. The deposits on hand and the investments purchased are not collateralized, secured, or guaranteed by the Commonwealth or any of its agencies, instrumentalities, or political subdivisions.

The Commonwealth's investment policy is to minimize credit and market risk while maintaining a competitive yield on its portfolio. The cash temporarily idle during this year was invested mainly in U.S. government securities, stocks, corporate bonds, repurchase agreements, Commonwealth securities, other trading securities, and short-term investments. These are primary government investments that are restricted and unrestricted.

### **Capital Assets and Debt Administration**

These basic financial statements include the capital assets and outstanding debt of the Commonwealth. A discussion of capital assets accounting and debt administration is included in the MD&A that is part of the basic financial statements. More detailed information about capital assets and outstanding debt can be found in the notes to the basic financial statements.

### **Risk Financing**

The Commonwealth purchases commercial insurance to cover casualty, theft, tort claims, and other losses. The current insurance policies have not been canceled or terminated. As it relates to workers' compensation, the Commonwealth's discretely presented component unit, the State Insurance Fund Corporation, provides workers' compensation to both public and private employees.

### **Financial Advisor and Fiscal Agent**

The principal functions of GDB are to act as financial advisor to and fiscal agent for the Commonwealth, its municipalities, and public corporations, in connection with the issuance of bonds and notes.

### **Economic Conditions and Outlook**

The economy of Puerto Rico is closely linked to the U.S. economy. The following exogenous variables are affected by the U.S. economy: exports, direct investment, transfer payments, interest rates, inflation, and tourist expenditures.

Puerto Rico has a diversified economy with manufacturing and services comprising its principal sectors. Manufacturing is the largest sector in terms of gross domestic product. Manufacturing in Puerto Rico is now more diversified than during the earlier phases of its industrial development and includes several industries less prone to business cycles. In the last three decades, industrial development has tended to be more capital intensive and more dependent on skilled labor.



The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page VII

The services sector, which includes finance, insurance, real estate, wholesale and retail trade, tourism, and other services, has shown a strong interaction with manufacturing, tourism, construction, and agriculture.

Tourism makes a significant contribution to economic activity. An estimated \$3.6 billion were spent by visitors in Puerto Rico during fiscal year 2008. San Juan has become the largest home port for cruise ships in the Caribbean and the fourth largest home port for cruise ships in the world. During the fiscal year 2008, the number of visitors increased 6.49% compared with fiscal year 2007. The construction sector was also an integral part of the economic activity from fiscal year 1999 through fiscal year 2008.

The Puerto Rico Planning Board's preliminary reports of the performance of the Puerto Rico's economy during fiscal year 2008 indicate that the economy registered a decrease of 2.5% in total real gross product. Gross product in fiscal year 2000 was \$41.4 billion and gross product in fiscal year 2008 was \$60.8 billion. This represents an increase in gross product of 46.9% from fiscal year 2000 to fiscal year 2008.

In terms of personal income, in fiscal year 2008, personal income per capita was \$14,236 compared to \$13,491 in 2007 and \$10,204 in 2000.

According to the Puerto Rico Department of Labor and Human Resources, during fiscal year 2008, the labor force was 1.37 million compared to 1.41 million in fiscal year 2007. The average unemployment rate increased from 10.4% during fiscal year 2007 to 11.0% in fiscal year 2008.

## **Major Initiatives**

### ***Tax Regime for Companies Doing Business in Puerto Rico***

Puerto Rico is a foreign tax jurisdiction for purposes of the U.S. Internal Revenue Code (IRC). However, the Commonwealth has multiple agreements with the U.S. Internal Revenue Service to ensure sharing of information and fiscalization. The Commonwealth has implemented various strategies to provide favorable tax treatment to U.S. and foreign companies doing business in the Commonwealth.

Most recently the Commonwealth introduced several changes to the tax incentive law of 1997, and during May 2008, the Commonwealth approved a new tax incentive law in part to counter the elimination of Section 936 of the IRC. All these efforts are expected to advance the manufacturing sector, which has a great impact on the rest of the economic activity.

### ***Public Sector Debt***

Historically, the Commonwealth has maintained, as a matter of fiscal policy, a prudent relationship between the growth of public sector debt and the growth of the economic base required to service that debt. During certain fiscal years, however, public sector debt increased at a greater rate than the rate of gross product primarily due to an increase in the amount of debt incurred to finance certain key infrastructure projects, which are important to the development of the economy and are expected to produce long-term economic benefits, and debt incurred to refinance outstanding debt to enable Puerto Rico to benefit from the historically low levels of interest rates and realize debt service savings. During fiscal year 2008, public sector debt decreased 9.07% mainly due to a refinancing of debt through a bond issuance by COFINA, a discretely presented component unit.

The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page VIII

### ***Prospects for the Future***

The Commonwealth is committed to research and pursue solutions to improve the Commonwealth's competitive economic performance and the quality of life for its people. The Commonwealth's economic development program is focused on initiatives aimed at producing more diversified and sustainable economic development.

The new administration has developed and commenced implementing a multiyear Fiscal Stabilization and Economic Reconstruction Plan that seeks to achieve fiscal balance and restore economic growth and acknowledges that fiscal stabilization is central to safeguarding the Commonwealth's investment-grade credit rating and restoring Puerto Rico's economic growth and development. During the first quarter of 2009, the Legislative Assembly enacted three bills providing for the implementation of this plan, which is composed of two main elements: the Fiscal Stabilization Plan (the Fiscal Plan) and the Economic Reconstruction Plan (the Economic Plan).

In addition, the new administration is in the process of designing and implementing a series of economic development initiatives with the aim of enhancing Puerto Rico's competitiveness and strengthening specific industry sectors. These economic development initiatives are intended to support the prospects of long-term and sustainable growth.

### **Fiscal Stabilization Plan**

**The Fiscal Plan has three main objectives:** (i) to stabilize the short-term fiscal situation, (ii) to safeguard and strengthen the Commonwealth's credit rating, and (iii) to achieve budgetary balance by fiscal year 2013. The Fiscal Plan, which is generally contained in Act No. 7 of March 9, 2009 (Act 7), includes expense-reduction measures, tax revenue enforcement measures, tax revenue increasing measures, and financial measures, as discussed below.

**Expense Reduction Measures.** A significant portion of Puerto Rico's current budget deficit is attributable to the accumulated effect of high operating expenses in the government. The Fiscal Plan seeks to reduce the recurring expense base of the government to make it consistent with the level of government revenues. The Fiscal Plan establishes a government-wide expense-reduction program aimed at reducing payroll and other operating expenses by \$2 billion.

Payroll expense is the most significant component of the government's recurring expense base. The reduction in payroll expenses contemplated by the Fiscal Plan will be implemented in three phases, with certain benefits conferred to participating employees, as follows:

Phase I: Incentivized Voluntary Resignation and Voluntary Permanent Workday Reduction Programs: The Incentivized Voluntary Resignation Program offered public employees a compensation incentive based on the time of service in the government. The Voluntary Permanent Workday Reduction Program was available to public employees with 20 or more years of service. The Workday Reduction Program consists of a voluntary reduction of one regular workday every fifteen calendar days, which is equivalent to approximately a 10% reduction in annual workdays. Phase I commenced in March 2009 and public employees had until April 27, 2009 to submit the required information to participate in the voluntary programs available under Phase I and be eligible for the Alternatives Program for Public Employees. On May 14, 2009, OMB announced that based on the number of employees who agreed to

The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page IX

participate in these programs, the expected reduction in expenses for fiscal year 2010 would be \$50 million.

Phase II: Involuntary layoff plan: As provided in Act 7, Phase II will go into effect only if the objective of reducing \$2 billion in expenses is not achieved after implementation of Phase I. Under Phase II, all employees with transitory, nonpermanent positions were terminated, effective July 3, 2009. In addition, Phase II provides for one or more rounds of involuntary layoffs commencing on July 3, 2009 and applies to all public employees unless specifically excluded by Act 7, strictly according to seniority in public service, starting with employees with least seniority. The plan excludes employees listed in Act 7 as providing "essential" services, those paid by federal funds, those on military leave, and political appointees and their trust employees (political appointees and their trust employees, who do not hold a permanent or career position in the government, are referred to herein as noncareer employees). Employees in Phase II will receive a severance package that includes health coverage payment for up to six months or until the former public employee is eligible for health insurance coverage at another job.

Phase III: Temporary suspension of certain provisions of laws, collective bargaining agreements, and other agreements: Phase III, which went into effect on March 9, 2009, imposes a temporary freeze of salary increases and other economic benefits included in laws, collective bargaining agreements, and any other agreements. Phase III will remain in effect for a period of two years, but this term may be shortened by the Governor by means of an Executive Order should OMB certify that the savings resulting from the implementation of Act 7's expense-reduction measures are sufficient to cover the law's objectives. OMB has indicated that the expected savings from the implementation of these measures is \$187 million for fiscal year 2010.

Public Employees Alternatives Program: The employees that elected to participate in the Incentivized Voluntary Resignation Program or the Voluntary Permanent Workday Reduction Program under Phase I, or that are subject to involuntary layoffs under Phase II, will be eligible for the Public Employees Alternatives Program. This program assists public employees in their transition into other productive alternatives, and offers vouchers for college education, technical education, and professional training, as well as for establishing a business and for relocation.

In addition, Act 7 provides that, for a period of two years, collective bargaining agreements that have already expired or that expire while the law is in effect and that relate to public employees may not be renegotiated or renewed.

The second element of the expense-reduction measures, which pertains to other operating expenses, will be conducted through an austerity program in combination with other measures, such as reduction in expenses of the public health plan, Executive Branch reorganization, and efficiency measures supported by budgeting and accounting processes, and information technology. The austerity program mandates a 10% reduction in other operational expenses, including cellular phone use, credit cards, and official vehicles.

*Tax Revenue Enforcement Measures.* The Fiscal Plan seeks to increase tax revenues by implementing a more rigorous and ongoing tax enforcement and compliance strategy. Specific tax enforcement initiatives

The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page X

include: (i) enhancements to federal grants and fund receipts, (ii) stronger collections and auditing efforts on Puerto Rico's sales and use tax, and (iii) a voluntary tax compliance program.

*Tax Increases.* The goal of achieving fiscal and budgetary balance requires a combination of measures that include the introduction of permanent and temporary tax increases. The Fiscal Plan includes six temporary and four permanent revenue increasing measures. With respect to temporary revenue increasing measures, the administration will implement: (i) a 5% surtax on income of certain individuals, (ii) a 5% surtax on income of certain corporations, (iii) a 5% income tax on credit unions (commonly known as *cooperativas* in Puerto Rico), (iv) a 5% income tax on Puerto Rico international banking entities, (v) a special property tax on residential real estate, and (vi) a moratorium on certain tax credits. The majority of these temporary measures will be in effect for three fiscal years beginning in fiscal year 2010. The permanent measures include (i) modifications to the alternative minimum tax for individuals and corporations, (ii) an increase in the excise taxes on cigarettes, (iii) new excise taxes on motorcycles, and (iv) an increase in the excise taxes on alcoholic beverages.

*Financial Measures.* The Commonwealth expects to carry out several financial initiatives in order to achieve fiscal stability throughout the implementation period of the Fiscal Plan. These financial measures include, among others, a financing or bond issuance program the proceeds of which would be used to bridge the structural budgetary imbalance during the implementation period of the Fiscal Plan and funding some initiatives in the Economic Plan.

The financial measures are mainly anchored on the bond-issuance program of COFINA. Act 7, in conjunction with Act No. 91 of May 13, 2006, as amended (Act 91), and Act No. 1 of January 14, 2009 (Act 1), allocated to COFINA, commencing on July 1, 2009, 2.75% (one-half of the tax rate of 5.5%) of the sales and use tax imposed by the central government, which increased COFINA's financing capacity and allows the Commonwealth to achieve fiscal stability throughout the implementation period of the Fiscal Plan.

In addition to the increased tax allocations to COFINA, the financial initiatives that were enacted into law include the creation of the Savings Notes for the Economic Cooperation of Puerto Rico (the Saving Notes Program) and allows for the refinancing of a portion of the existing debt of the Public Buildings Authority. The Savings Notes Program consists of an issuance of up to \$20 million in short-term general obligation notes for retail distribution to Puerto Rico residents.

The Commonwealth expects that its Fiscal Plan will provide more fiscal stability, thereby safeguarding and strengthening Puerto Rico's credit rating. The Commonwealth further expects that the resulting fiscal structure will be sustainable and conducive to economic growth and development.

### ***Economic Reconstruction Plan***

To balance the impact of the Fiscal Plan, the new Commonwealth has developed and is implementing an economic reconstruction program to stimulate growth in the short term and lay the foundation for long-term economic development. In addition, the new Commonwealth is developing a comprehensive, long-term, economic development program aimed at improving Puerto Rico's overall global relevance, competitiveness, and business environment, and increasing private-sector capital formation and participation in the economy.



The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page XI

The Economic Plan consists of three main components: (i) two economic stimulus programs, (ii) Public-Private Partnerships, and (iii) a supplemental stimulus plan.

*Economic Stimulus Programs.* The cornerstone of Puerto Rico's short-term economic reconstruction plan is the implementation of two economic stimulus programs aimed at reigniting growth and counterbalancing any adverse effects associated with the Fiscal Plan. The economic stimulus programs consist of Puerto Rico's participation in ARRA (also referred to herein as the Federal Stimulus) and a local plan (the Local Stimulus) designed to complement the Federal Stimulus.

- **Federal Stimulus Program:** Puerto Rico is eligible to participate in ARRA because of its status as a U.S. jurisdiction. Puerto Rico expects to receive up to \$5 billion in stimulus funds from ARRA. The funds will be distributed in four main categories: relief to individuals, budgetary and fiscal relief, taxpayers' relief, and capital improvements. This Federal Stimulus coming from ARRA places an emphasis in relief for individuals and taxpayers. In terms of government programs, the Federal Stimulus allocates funds to education, agriculture and food assistance, health, housing and urban development, labor, and transportation, among others.
- **Local Stimulus Program:** The Commonwealth has formulated the Local Stimulus to supplement the Federal Stimulus and ameliorate specific local challenges associated with the local mortgage market, the availability of credit, and the infrastructure and construction sectors. Despite the fact that the Local Stimulus amounts to a \$500 million investment by the government, it has been estimated that its effect will be greater due to its loan-guarantee programs, which will be coordinated in collaboration with commercial banks in Puerto Rico. The Local Stimulus is composed of three main elements: (i) capital improvements, (ii) stimulus for small- and medium-sized businesses, and (iii) consumer relief in the form of direct payments to retirees, mortgage-debt restructuring for consumers that face risk of default, and consumer stimulus for the purchase of housing.

*Public-Private Partnerships.* The Commonwealth believes that Public-Private Partnerships (PPPs) represent an important tool for economic development, particularly in times of fiscal imbalance. PPPs are collaborations between government and nongovernmental entities – such as private-sector, nonprofit organizations, credit unions, and township corporations (*corporaciones municipales*) – to develop infrastructure projects, manage government assets or provide services. The nongovernmental partner takes on certain responsibilities and risks related to the development of the project in exchange for receiving the benefits of operating it.

PPPs provide the opportunity for lower project development costs, reduction of financial risk, creation of additional revenue sources, establishment of service quality metrics, and re-direction of government resources to focus on the implementation of public policy.

The Commonwealth is working on establishing the legal framework that will implement the procedures for establishing PPPs. Puerto Rico has opportunities for the establishment of PPPs in the areas of highways, ports, transportation, solid waste, potable water, and renewable energy, among others.

*Supplemental Stimulus Plan.* The Economic Plan includes a Supplemental Stimulus Plan, which will provide investment in strategic areas with the objective of laying the foundations for long-term growth in Puerto Rico. The Supplemental Stimulus will begin after the first year of implementation of the Federal and Local Stimuli. The coordinated implementation of the Supplemental Stimulus during the second year

The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page XII

of the Federal and Local Stimuli will reinforce continuity in reigniting economic growth while making key investments for long-term development.

The Supplemental Stimulus will be conducted by GDB through a combination of direct investments and guaranteed lending. Specifically, the Supplemental Stimulus will target critical areas such as the banking system, key infrastructure projects, public capital improvement programs, private-sector lending to specific industries, and the export and research-and-development knowledge industries. The Supplemental Stimulus will take into account the strategic needs that Puerto Rico must fulfill in order to become a more competitive player in its region and in the global economy.

The Supplemental Stimulus is intended to complement a comprehensive Economic Development Program that will be implemented by the Department of Economic Development and Commerce of the Commonwealth, as discussed below.

### ***Economic Development Program***

The Department of Economic Development and Commerce of the Commonwealth (DEDC), in coordination with other government agencies, is in the process of formulating and implementing a series of economic development initiatives with the goal of laying the groundwork for sustainable economic growth. These initiatives are centered on the dual mission of fostering multi-sector growth while reducing costs and barriers to business and investment, and are a medium-to-long-term counterpart to the Economic Reconstruction Plan and the Supplemental Stimulus Plan described above. The economic development initiatives are aimed at improving Puerto Rico's overall global relevance, competitiveness, and business environment and seek to increase private-sector capital formation and participation in the Puerto Rico economy.

The administration will emphasize three main initiatives to enhance Puerto Rico's competitive position: (i) overhauling the permitting process, (ii) reforming the labor market, and (iii) reducing energy costs.

The first initiative, the reengineering of Puerto Rico's permitting and licensing process, has already been initiated and legislation has been filed. In the short term, this restructuring is focused on eliminating the significant backlog of unprocessed permits that are currently in the pipeline of various government agencies. Longer term, this effort seeks to significantly reduce the number of inter-agency processes and transactions currently required by creating a centralized, client-focused system that simplifies and shortens the permitting process for applicants.

Initiatives will also be undertaken with the purpose of strengthening Puerto Rico's labor market. The Commonwealth seeks to encourage greater labor-force participation by providing the private sector with more flexibility in establishing feasible labor arrangements. One focus of the labor-market reform will be the modernization of Puerto Rico's regulatory framework. Legislative changes to be introduced will focus on bringing out-of-date labor laws and regulations in line with U.S. and international standards with respect to such matters as flex-time arrangements, overtime rules, workers' compensation, and benefit requirements, among others. This labor reform is expected to provide a significant improvement in Puerto Rico's competitiveness in the global marketplace.

The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page XIII

The Commonwealth considers the adoption of a new energy policy to be critical for Puerto Rico's competitiveness. Presently, fluctuations in oil prices have a significant effect on Puerto Rico's overall economic performance. The Commonwealth will focus on reducing Puerto Rico's dependence on fossil fuels, particularly oil, through the promotion of diverse, renewable-energy technologies. By implementing a new energy policy, the Commonwealth will seek to lower energy costs, reduce energy-price volatility, and establish environmentally sustainable energy production through a reduction in ecologically harmful emissions. The Commonwealth is facilitating the development of several initiatives, including the wheeling of energy, conservation efforts, and the installation of new renewable generation capacity, among others. These initiatives are expected not only to address energy prices in Puerto Rico, but also to provide for a means of attracting investment in the energy sector.

The Commonwealth will complement these competitive initiatives with specific strategic initiatives with the objective of creating jobs and increasing economic activity across various sectors of the Puerto Rico economy. The Commonwealth has natural or structural competitive advantages in several areas, such as pharmaceutical and biotechnology manufacturing. These advantages provide opportunities to further economic activities in manufacturing, science and technology, tourism, renewable energy, trade, and professional services. The specific initiatives will be designed to promote sustainable economic growth while diversifying Puerto Rico's economic base.

Besides its current budgetary issues the other main fiscal challenge faced by the Commonwealth involves resolving the increasing unfunded pension liability of both the Retirement System of the Employees of the Government and Judiciary (Employees' Retirement System) and the Puerto Rico System of Annuities and Pensions for Teachers (the Teachers Retirement System). The Systems have engaged actuarial consultants and legal experts to review and redesign specifics on how the various retirement laws may be modified to reduce their actuarial liabilities in the short and medium term, as well as financial and investment tools that are available to reduce system risks.

### **Financial Condition**

The MD&A, which can be found immediately following the independent auditors' report, provides an overview of the Commonwealth's financial activities addressing both governmental and business-type activities reported in the government wide financial statements. In addition, the MD&A focuses on the Commonwealth's major funds. Component units and fiduciary activities are excluded from the MD&A.

### ***Estimated Fiscal Year 2009 Compared to Actual Fiscal Year 2008***

As revised, estimated general fund total revenues for fiscal year 2009 is \$7.6 billion, representing a decrease of \$798 million from fiscal year 2008 revenue. The 2009 revenues projections and subsequent revision take into account (i) the Puerto Rico Planning Board's downward revision of its forecast for real growth in gross national product from 0.8% to (2.1)%, and (ii) the increase in the oil prices which directly affected income and excise tax collections.

The Honorable Governor of Puerto Rico  
Members of the Legislature, and People of Puerto Rico  
August 12, 2009  
Page XIV

## **Other Information**


### *Acknowledgements*

The preparation of this report requires the collective efforts of numerous finance personnel throughout the Commonwealth and is made possible only with the cooperation and support of the Executive, Legislative, and Judicial branch agencies, and component units of the Commonwealth. We sincerely appreciate the dedicated efforts of all these individuals.

The report could not have been accomplished without the professionalism and dedication of Luis Báez Black and Alejandro Sánchez Rivera from our accounting team as well as the rest of the personnel of the Central Government Accounting area. Also, we would like to give special thanks to our independent auditors, KPMG LLP, for their advice and commitment.

This report continues our commitment to the people of the Commonwealth of Puerto Rico, the Governor, the Legislature, and the financial community to maintain our basic financial statements in conformance with the highest standards of financial accountability.

Respectfully submitted,



Hon. Juan Carlos Puig  
Secretary of the Treasury



SECRETARY OF THE TREASURY



## COMMONWEALTH OF PUERTO RICO

### Principal Officials

**Luis G. Fortuño Burset**  
Governor

### Members of Cabinet

**Juan C. Blanco Urrutia**  
Chief of Staff

**Kenneth McClintock**  
Secretary of State

**Antonio Sagardía de Jesús**  
Secretary of Justice

**Juan C. Puig Morales**  
Secretary of the Treasury

**Carlos E. Chardón**  
Secretary of Education

**Miguel Romero Lugo**  
Secretary of Labor and  
Human Resources

**Dr. Ricardo Moscoso**  
Acting Secretary of Health

**Javier Rivera Aquino**  
Secretary of Agriculture

**Rubén A. Hernández Gregorat**  
Secretary of Transportation and  
Public Works

**José R. Perez Riera**  
Secretary of Economic  
Development and Commerce

**Yanitsia Irizarry**  
Secretary of Family Affairs

**Yesef Y. Cordero Lebrón**  
Secretary of Housing

**Daniel Galán Kercadó**  
Secretary of Natural and  
Environmental Resources

**Luis G. Rivera Marín**  
Secretary of Consumer Affairs

**Henry Newmann**  
Secretary of Sports and  
Recreation

**Carlos M. Molina Rodríguez**  
Secretary of Corrections and  
Rehabilitation

---

### LEGISLATIVES OFFICERS

**Thomas Rivera Schatz**  
President, Senate

**Jennifer González Colón**  
Speaker, House of  
Representatives

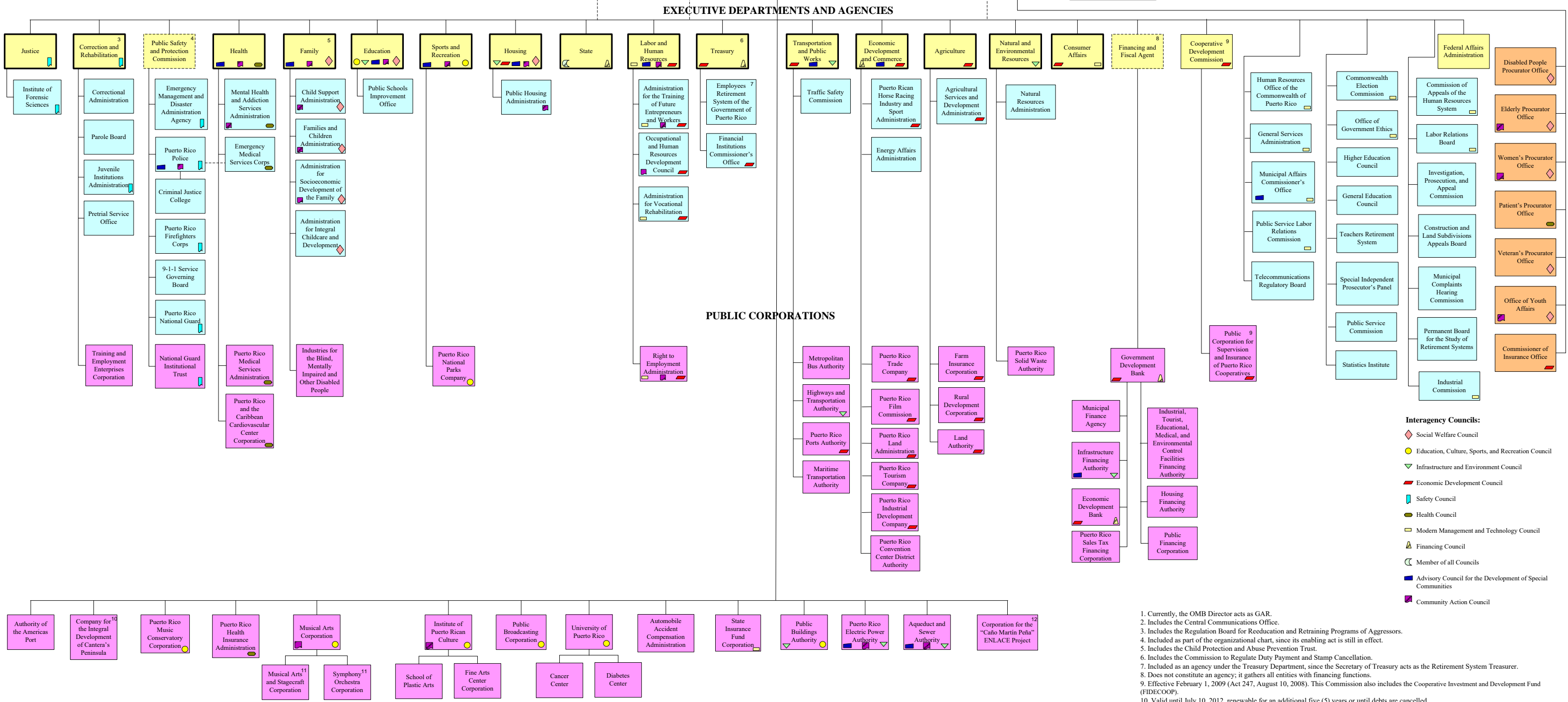
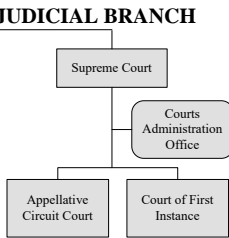
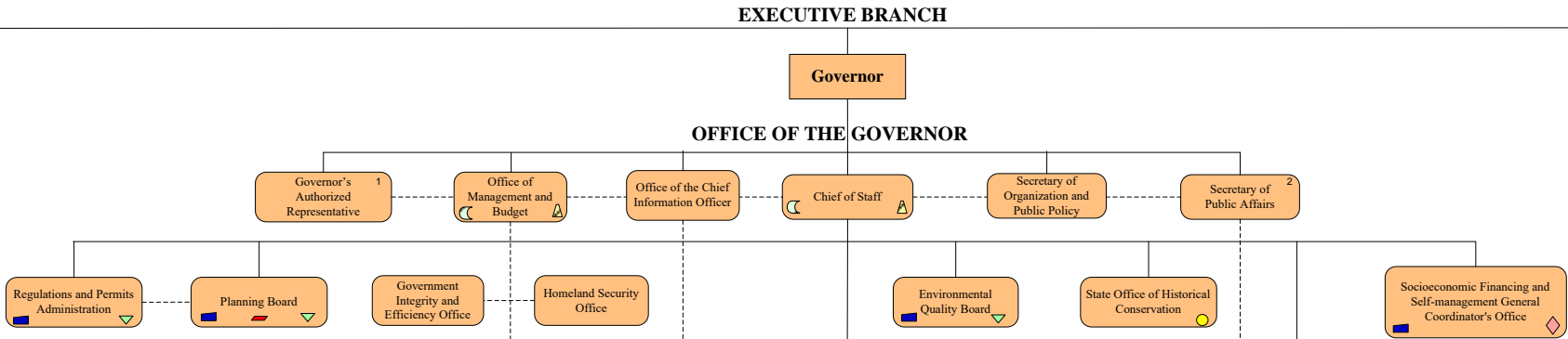
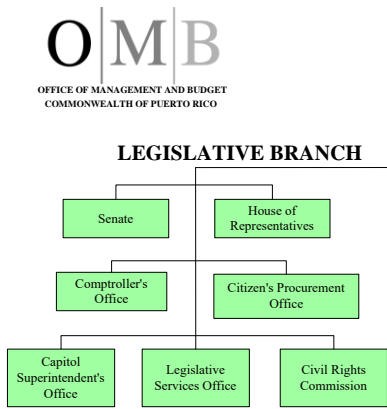
---

### FISCAL OFFICERS

**María Sánchez Brás**  
Director, Office of Management  
and Budget

**Carlos M. García**  
President, Government  
Development Bank for  
Puerto Rico

COMMONWEALTH OF PUERTO RICO  
FUNCTIONAL ORGANIZATIONAL STRUCTURE



1. Currently, the OMB Director acts as GAR.  
2. Includes the Central Communications Office.  
3. Includes the Regulation Board for Reeducation and Retraining Programs of Aggressors.  
4. Included as part of the organizational chart, since its enabling act is still in effect.  
5. Includes the Child Protection and Abuse Prevention Trust.  
6. Includes the Commission to Regulate Duty Payment and Stamp Cancellation.  
7. Included as an agency under the Treasury Department, since the Secretary of Treasury acts as the Retirement System Treasurer.  
8. Does not constitute an agency; it gathers all entities with financing functions.  
9. Effective February 1, 2009 (Act 247, August 10, 2008). This Commission also includes the Cooperative Investment and Development Fund (FIDECOOP).  
10. Valid until July 10, 2012, renewable for an additional five (5) years or until debts are cancelled.  
11. Subsidiaries of the Musical Arts Corporation (Acts 42 & 44, May 12, 1980).  
12. Valid until September 24, 2024, renewable for an additional five (5) years or until debts are cancelled.

## **FINANCIAL SECTION**



**KPMG LLP**  
American International  
Suite 1100  
250 Muñoz Rivera Avenue  
San Juan, PR 00918-1819

## **Independent Auditors' Report**

The Honorable Governor and Legislature  
Commonwealth of Puerto Rico  
San Juan, Puerto Rico:

We have audited the accompanying financial statements of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the Commonwealth of Puerto Rico (the Commonwealth) as of and for the year ended June 30, 2008, which collectively comprise the Commonwealth's basic financial statements as listed in the table of contents. These financial statements are the responsibility of the Commonwealth's management. Our responsibility is to express opinions on these financial statements based on our audit. We did not audit the financial statements of the Public Buildings Authority capital project fund or The Children's Trust special revenue fund (major funds), which represent 1% and 0%, respectively, of the assets and revenue of the governmental activities. We also did not audit the financial statements of the following activities, funds, and component units:

- Puerto Rico Public Housing Administration, Human Resources and Occupational Development Council, and the Office for the Administration of the Assets of the Urban Renovation and Housing Corporation of the Commonwealth of Puerto Rico, which collectively represent 23% and 4%, respectively, of the assets and revenue of the general fund and 6% and 3%, respectively, of the assets and revenue of the governmental activities;
- The Additional Lottery System, which represents 68% and 39%, respectively, of the assets and revenue of the lotteries major fund and 13% and 29%, respectively, of the assets and revenue of the business-type activities;
- Public Buildings Authority special revenue and debt service funds, the Children's Trust debt service fund, and the Puerto Rico Maritime Shipping Authority debt service fund which collectively represent 5% and 8%, respectively, of the assets and revenue of the aggregate remaining fund information and 4% and 1%, respectively, of the assets and revenue of the governmental activities;
- The pension trust funds, which represent 81% and 90%, respectively, of the assets and revenue of the aggregate remaining fund information; and
- Entities identified in note 2 that are presented as discretely presented component units, which collectively represent 87% and 83%, respectively, of the assets and revenue of the aggregate discretely presented component units.

These financial statements were audited by other auditors whose reports thereon have been furnished to us, and our opinions, insofar as they relate to the amounts included for the activities, funds, and component units indicated above, are based on the reports of the other auditors.

We conducted our audit in accordance with auditing standards generally accepted in the United States of America. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes consideration of internal control over financial reporting as a basis for designing audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the Commonwealth's internal control over financial reporting. Accordingly, we express no such opinion. An audit also includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements, assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audit provides a reasonable basis for our opinions.

In our opinion, based on our audit and the reports of the other auditors, the financial statements referred to above present fairly, in all material respects, the respective financial position of the governmental activities, the business-type activities, the aggregate discretely presented component units, each major fund, and the aggregate remaining fund information of the Commonwealth of Puerto Rico as of June 30, 2008, and the respective changes in financial position, and, where applicable, cash flows thereof and the respective budgetary comparison for the general fund for the year then ended in conformity with U.S. generally accepted accounting principles.

As described in note 1(u) to the basic financial statements, the Commonwealth adopted the provisions of Governmental Accounting Standards Board Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits other than Pensions*, during the year ended June 30, 2008.

The management's discussion and analysis on pages 3 through 19 and the schedule of funding progress on page 163 are not a required part of the basic financial statements but are supplementary information required by U.S. generally accepted accounting principles. We and the other auditors have applied certain limited procedures, which consisted principally of inquiries of management regarding the methods of measurement and presentation of the required supplementary information. However, we did not audit the information and express no opinion on it.

Our audit was conducted for the purpose of forming opinions on the financial statements that collectively comprise the Commonwealth's basic financial statements. The introductory section, combining and individual fund financial statements and schedules and statistical section listed in the table of contents are presented for purposes of additional analysis and are not a required part of the basic financial statements. These combining and individual fund financial statements have been subjected to the auditing procedures applied by us and the other auditors in the audit of the basic financial statements and, in our opinion, are fairly stated in all material respects in relation to the basic financial statements taken as a whole. The introductory and statistical sections of this report listed in the table of contents have not been subjected to the auditing procedures applied in the audit of the basic financial statements and, accordingly, we express no opinion on them.

KPMG LLP

August 12, 2009

Stamp No. 2446203 of the Puerto Rico  
Society of Certified Public Accountants  
was affixed to the record copy of this report.



## **COMMONWEALTH OF PUERTO RICO**

### **Management's Discussion and Analysis (Unaudited)**

June 30, 2008

Management of the Commonwealth of Puerto Rico (the Commonwealth) provides this Management's Discussion and Analysis for the readers of the Commonwealth's basic financial statements. This narrative overview and analysis of the financial activities of the Commonwealth is for the fiscal year ended June 30, 2008, and is intended to provide an easily readable explanation of the information provided in the attached basic financial statements. We encourage readers to consider this information with the Commonwealth's basic financial statements that follow.

### **Financial Highlights – Primary Government**

#### ***Government-wide Highlights***

- The Commonwealth reported a deficit of \$17.1 billion as of June 30, 2008, an improvement in the financial position of \$587 million from last year's balances. The accumulated deficit is principally the result of the Commonwealth's practice of issuing debt and transferring such funds to its discretely presented component units in order for them to carry out the corresponding construction programs and to borrowings made by the primary government of the Commonwealth to cover operational needs.
- The Commonwealth's total deficit decreased by \$587 million (a 3% decrease) as a result of this year's operations. The governmental activities' deficit decreased by \$620 million (a 3% decrease), while net assets of the business-type activities showed a decrease of \$33 million (a 4% decrease).
- The Commonwealth's governmental activities had total revenue of \$17.3 billion, which exceeded total expenses of \$17.0 billion, excluding transfers received from business-type activities amounting to \$310 million.
- The Commonwealth's business-type activities had total revenue of \$1,274 million, which exceeded total expenses of \$998 million, excluding transfers made to the governmental activities amounting to \$310 million.

#### ***Fund Highlights***

- As of June 30, 2008, the Commonwealth's governmental funds reported a combined ending fund deficit of \$910 million, a decrease of \$1,021 million in comparison with the prior year combined fund balance, while the business-type activities decreased its net assets by \$33 million to reach \$724 million.
- The general fund reported a deficit of \$1.8 billion as of June 30, 2008, an increase of \$1.3 billion in comparison with the prior year.
- The unemployment insurance fund reported net assets of \$369 million while the lotteries fund reported a deficit of \$153 million. The deficit in the lottery funds was a result of the transfers of investments made to the general fund a few years ago.

#### ***Long-Term Debt***

- Total long-term obligations as of June 30, 2008 were \$26.4 billion, from which \$1.6 billion are due within one year. The long-term obligation of the governmental activities decreased by \$1.4 billion (5.0%) to \$26.0 billion when compared to the prior year, while the business-type activities increased by \$52 million (14.7%) to \$409 million. The decrease in governmental activities' long-term obligations was mainly due to the payments made by the Puerto Rico Sales Tax Financing Corporation, a component unit of the Commonwealth, to refinance or retire extra constitutional debt of the Commonwealth and certain debt of

## COMMONWEALTH OF PUERTO RICO

### Management's Discussion and Analysis (Unaudited)

June 30, 2008

component units in the amount of approximately \$4.2 billion. The payments made by the Puerto Rico Sales Tax Financing Corporation on behalf of the Commonwealth are reported as a special item in the statement of activities.

#### Overview of the Financial Statements

This discussion and analysis is intended to serve as an introduction to the Commonwealth's basic financial statements. The Commonwealth's basic financial statements include three components: (1) government-wide financial statements, (2) fund financial statements, and (3) notes to the financial statements. This report also contains additional required supplementary information in addition to the basic financial statements themselves. These components are described below:

#### *Basic Financial Statements*

The basic financial statements include two kinds of financial statements that present different views of the Commonwealth—the government-wide financial statements and the fund financial statements and combining major component units financial statements. These financial statements also include the notes to the basic financial statements that explain some of the information in the financial statements and provide more detail.

#### Government-Wide Financial Statements

The government-wide financial statements provide a broad view of the Commonwealth's operations in a manner similar to a private sector business. The statements provide both short- and long-term information about the Commonwealth's financial position, which assists in assessing the Commonwealth's economic condition at the end of the fiscal year. These are prepared using the flow of economic resources measurement focus and the accrual basis of accounting. This basically means they follow methods that are similar to those used by most businesses. They take into account all revenue and expenses connected with the fiscal year even if cash involved has not been received or paid. The government-wide financial statements include two statements:

- ***Statement of Net Assets (Deficit)*** – This presents all of the government's assets and liabilities with the difference between the two reported as net assets (deficit). Over time, increases or decreases in the Commonwealth's net assets (deficit) may serve as a useful indicator of whether the financial position of the Commonwealth is improving or deteriorating.
- ***Statement of Activities*** – This presents information showing how the government's net assets (deficit) changed during the most recent fiscal year. All changes in net assets (deficit) are reported as soon as the underlying event giving rise to the change occurs, regardless of the timing of related cash flows. Thus, revenue and expenses are reported in this statement for some items that will not result in cash flows until future fiscal periods (such as uncollected taxes and earned but unused vacation leave). This statement also presents a comparison between direct expenses and program revenue for each function of the Commonwealth.

Both of the above financial statements have separate sections for three different types of Commonwealth programs or activities. These three types of activities are as follows:

- ***Governmental Activities*** – The activities in this section are mostly supported by taxes and intergovernmental revenue (federal grants). Most services normally associated with Commonwealth

## COMMONWEALTH OF PUERTO RICO

### Management's Discussion and Analysis (Unaudited)

June 30, 2008

government fall into this category, including general government, public safety, health, public housing and welfare, education, and economic development.

- **Business-Type Activities** – These functions normally are intended to recover all or a significant portion of their costs through user fees and charges to external users of goods and services. These business-type activities of the Commonwealth include the operations of the following major funds: unemployment insurance fund (administered by the Commonwealth Employment Security Bureau) and the lotteries.
- **Component Units** – These are organizations that are legally separate from the Commonwealth, but either the Commonwealth is financially accountable for them or the nature and significance of their relationship with the Commonwealth are such that their exclusion would cause the Commonwealth's financial statements to be misleading or incomplete. The Commonwealth has both blended and discretely presented component units.
- **Blended Component Units** – Although legally separate entities, these are in substance part of the primary government's operations. Therefore, data from blended component units are integrated into the appropriate funds for reporting purposes.

The Commonwealth's three blended component units are:

- Public Buildings Authority,
- Puerto Rico Maritime Shipping Authority, and
- The Children's Trust.
- **Discretely Presented Component Units** – These are operations for which the Commonwealth has financial accountability, but they have certain independent qualities as well. For the most part, these entities operate similar to private sector businesses and the business-type activities described above. The Commonwealth's discretely presented component units are presented in two categories, major and nonmajor. This separation is determined by the relative size of the entities' assets, liabilities, revenue, and expenses in relation to the total of all component units.

The Commonwealth's 43 discretely presented nonmajor component units are combined into a single column for reporting in the fund financial statements. Complete financial statements of the individual component units can be obtained from their respective administrative offices. Addresses and other additional information about the Commonwealth's component units are presented in note 1 to the basic financial statements.

The Commonwealth's eight discretely presented major component units are:

- Government Development Bank for Puerto Rico,
- Puerto Rico Highways and Transportation Authority,
- Puerto Rico Electric Power Authority,
- Puerto Rico Aqueduct and Sewer Authority,
- Puerto Rico Infrastructure Financing Authority,



## COMMONWEALTH OF PUERTO RICO

### Management's Discussion and Analysis (Unaudited)

June 30, 2008

- Puerto Rico Health Insurance Administration,
- Puerto Rico Sales Tax Financing Corporation, and
- University of Puerto Rico.

The government-wide financial statements can be found immediately following this discussion and analysis.

### Fund Financial Statements

A fund is a grouping of related accounts that is used to maintain control over resources that have been segregated for specific activities or objectives. The Commonwealth, like other states and local governments, uses fund accounting to help ensure and demonstrate compliance with finance-related legal requirements. The fund financial statements focus on individual parts of the Commonwealth government, reporting the Commonwealth's operations in more detail than the government-wide financial statements. All of the funds of the Commonwealth can be divided into three categories. It is important to note that these fund categories use different accounting approaches and should be interpreted differently. The three categories of funds are the following:

- ***Governmental Funds Financial Statements*** – Most of the basic services provided by the Commonwealth are financed through governmental funds. Governmental funds are used to account for essentially the same functions reported as governmental activities in the government-wide financial statements. However, unlike the government-wide financial statements, the governmental fund financial statements focus on near-term inflows and outflows of expendable resources. They also focus on the balances of expendable resources available at the end of the fiscal year. Such information may be useful in evaluating the government's near-term financing requirements. This approach is known as using the flow of current financial resources measurement focus and the modified-accrual basis of accounting. These statements provide a detailed short-term view of the Commonwealth's finances that assist in determining whether there will be adequate financial resources available to meet the current needs of the Commonwealth. Because the focus of governmental funds is narrower than that of the government-wide financial statements, it is useful to compare the information presented for governmental funds with similar information presented for governmental activities in the government-wide financial statements. By doing so, readers may better understand the long-term impact of the government's near-term financing decisions. Both the governmental fund balance sheet and the governmental fund statement of revenue, expenditures, and changes in fund balances provide a reconciliation to facilitate this comparison between governmental funds and the governmental activities. These reconciliations are presented on the page immediately following each governmental fund financial statement.

The Commonwealth has five major governmental funds. That is, each major fund is presented in a separate column in the governmental funds balance sheet and in the governmental funds statement of revenue, expenditures, and changes in fund balances. The Commonwealth's five major governmental funds are the general fund, The Children's Trust special revenue fund, the debt service fund, the capital projects fund, and the Public Buildings Authority capital projects fund. The remaining nonmajor governmental funds are grouped and presented in a single column in the governmental funds financial statements. The basic governmental funds financial statements can be found immediately following the government-wide financial statements.

## COMMONWEALTH OF PUERTO RICO

### Management's Discussion and Analysis (Unaudited)

June 30, 2008

- ***Proprietary Funds Financial Statements*** – These funds are used to show activities that operate more like those of commercial enterprises. Because these funds charge fees for services provided to outside customers including local governments, they are known as enterprise funds. Proprietary funds provide the same type of information as the government-wide financial statements, only in more detail. Like the government-wide financial statements, proprietary fund financial statements use the accrual basis of accounting. There is no reconciliation needed between the government-wide financial statements for business-type activities and the proprietary fund financial statements. The Commonwealth has two major enterprise funds. As previously mentioned, they are the operations of the unemployment insurance trust fund (administered by the Commonwealth's Employment Security Bureau) and the lotteries. Other nonmajor proprietary funds are grouped and presented in a separate column in the proprietary funds financial statements. The basic proprietary funds financial statements can be found immediately following the governmental fund financial statements.
- ***Fiduciary Funds and Similar Component Units Financial Statements*** – These funds are used to account for resources held for the benefit of parties outside the Commonwealth government. Fiduciary funds are not reflected in the government-wide financial statements because the resources of these funds are not available to support the Commonwealth's own programs. The accounting used for fiduciary funds is much like that used for proprietary funds. They use the accrual basis of accounting. The Commonwealth's fiduciary funds are the pension trust funds (three separate retirement systems for employees, which are fiduciary component units of the Commonwealth) and the agency funds (which account for the assets held for distribution by the Commonwealth as an agent for other governmental units, other organizations, or individuals). The basic fiduciary funds and similar component units' financial statements can be found immediately following the proprietary funds financial statements.

### Component Units Financial Statements

As mentioned above, these are operations, for which the Commonwealth has financial accountability, but they have certain independent qualities as well, and they operate similar to private sector businesses. The government-wide financial statements present information for the component units in a single column on the statement of net assets. Also, some information on the statement of changes in net assets is aggregated for component units. The combining statement of net assets and the combining statement of activities provide detail for each major component unit and the nonmajor component units in aggregate. The basic combining financial statements for major component units can be found immediately following the fiduciary funds financial statements.

### Notes to Basic Financial Statements

The notes provide additional information that is essential to a full understanding of the data provided in the government-wide and the fund financial statements. The notes to the basic financial statements can be found immediately following the component units' financial statements.

### Required Supplementary Information

The basic financial statements include immediately following its notes a section of required supplementary information. This section includes information of funding progress for the Commonwealth's three separate retirement systems.

## COMMONWEALTH OF PUERTO RICO

### Management's Discussion and Analysis (Unaudited)

June 30, 2008

#### Government-Wide Financial Analysis

##### *Net Assets (Deficit)*

As noted earlier, net assets (deficit) may serve over time as a useful indicator of a government's financial position. Total assets and total liabilities of the Commonwealth's primary government at June 30, 2008 amounted to \$13.6 billion and \$30.7 billion, respectively, for a net deficit of \$17.1 billion, compared to a \$17.7 billion net deficit at the beginning of the current year, as restated.

A portion of the Commonwealth's net assets (deficit) reflects its investment in capital assets such as land, buildings, and equipment, less any related debt used to acquire those assets that are still outstanding. The Commonwealth uses these capital assets to provide services to its residents; consequentially, these assets are not available for future spending. Although the Commonwealth's investment in its capital assets is reported net of related debt, it should be noted that the resources needed to repay this debt must be provided from other sources, since the capital assets themselves cannot be used to liquidate these liabilities.

An additional portion of the Commonwealth's net assets (deficit) represents resources that are subject to external restrictions on how they may be used. An otherwise positive remaining balance would be used to meet the Commonwealth's ongoing obligations to its residents and creditors. Internally imposed designations of resources are not presented as restricted net assets. At the end of the current fiscal year, the Commonwealth is able to report positive balances in two categories of net assets, and a deficit, both for the government as a whole as well as for its separate governmental and business-type activities.

As explained earlier, the net deficit of the primary government primarily results from the Commonwealth's practice of issuing debt and transferring such funds to the component units so that they can carry out the construction projects. The primary government retains the debt while the component units report the corresponding asset financed by such debt.

Total assets decreased by \$980 million during fiscal year 2008 when compared to the prior fiscal year. This decrease is the net effect of various increases and decreases as follows:

- Unrestricted and restricted cash decreased by \$933 million when compared to the prior year. The decrease was mainly due to a decrease of approximately \$817 million in tax revenue when compared to the prior year.
- Net decrease of \$457 million in the receivables when compared to prior year.
- Additions to capital assets, retirements, and depreciation expense amounted to approximately \$429 million, \$77 million, and \$244 million, respectively.

# COMMONWEALTH OF PUERTO RICO

## Management's Discussion and Analysis (Unaudited)

June 30, 2008

Total liabilities decreased by \$1.6 billion during the current fiscal year when compared to the prior fiscal year. This fluctuation is mainly prompted by the issuance of bonds for \$3.7 billion during fiscal year 2008 net of the payment of bonds and notes amounting to \$6.5 billion and an increase in the liabilities associated with net pension obligation and legal claims amounting to \$747 million and \$226 million, respectively.

### Commonwealth's Net Assets (Deficit) – Primary Government

June 30, 2008

(Expressed in thousands)

	<b>Governmental activities</b>	<b>Business-type activities</b>	<b>Total</b>
Current assets	\$ 2,680,800	805,396	3,486,196
Capital assets	7,551,707	674	7,552,381
Other assets	2,226,368	358,225	2,584,593
<b>Total assets</b>	<b>\$ 12,458,875</b>	<b>1,164,295</b>	<b>13,623,170</b>
Other liabilities	\$ 4,289,357	31,618	4,320,975
Long-term liabilities	25,984,848	408,514	26,393,362
<b>Total liabilities</b>	<b>\$ 30,274,205</b>	<b>440,132</b>	<b>30,714,337</b>
Invested in capital assets, net of related debt	\$ 3,979,308	674	3,979,982
Restricted	721,521	33,803	755,324
Unrestricted	(22,516,159)	689,686	(21,826,473)
<b>Total net assets (deficit)</b>	<b>\$ (17,815,330)</b>	<b>724,163</b>	<b>(17,091,167)</b>

**COMMONWEALTH OF PUERTO RICO**

Management's Discussion and Analysis (Unaudited)

June 30, 2008

**Commonwealth's Net Assets (Deficit) – Primary Government**

June 30, 2007

(Expressed in thousands)

	<b>Governmental activities</b>	<b>Business-type activities</b>	<b>Total</b>
Current assets	\$ 3,658,200	849,289	4,507,489
Capital assets	7,407,848	674	7,408,522
Other assets	2,389,190	297,636	2,686,826
Total assets	<u>\$ 13,455,238</u>	<u>1,147,599</u>	<u>14,602,837</u>
Other liabilities	\$ 4,544,527	34,062	4,578,589
Long-term liabilities	27,349,605	356,202	27,705,807
Total liabilities	<u>\$ 31,894,132</u>	<u>390,264</u>	<u>32,284,396</u>
Invested in capital assets, net of related debt	\$ 3,635,271	674	3,635,945
Restricted	331,051	910,479	1,241,530
Unrestricted	(22,405,216)	(153,818)	(22,559,034)
Total net assets (deficit)	<u>\$ (18,438,894)</u>	<u>757,335</u>	<u>(17,681,559)</u>

The net assets of the governmental activities as of June 30, 2007 were restated by \$3.4 million as a result of an underestimation of capital assets.

***Changes in Net Assets***

The Commonwealth's net deficit decreased by \$587 million or 3% from last year's total net deficit. Approximately 44% of the Commonwealth's total revenue came from taxes, while 26% resulted from grants and contributions (primarily, federal financial assistance). Charges for various goods and services provided represented 4% of the total revenue. The Commonwealth's expenses cover a range of services. The largest expenses were for education, public housing, health, and welfare, public safety, and general government. In 2008, governmental activities' expenses exceeded program revenue by \$11.9 billion, resulting in the use of \$12.5 billion in general revenue (mostly, taxes) and transfers. On the other hand, program revenue from business-type activities in 2008 exceeded expenses by approximately \$241 million. In addition, the business-type activities had unrestricted investments earnings of \$35 million and transfers to the governmental activities amounting to \$310 million.

Governmental activities decreased the Commonwealth's net deficit by \$620 million. The Commonwealth implemented the sales and use tax during fiscal year 2007. Fiscal year 2008 is the first year containing 12 months of sales and use tax. This sales and use tax resulted in higher tax revenues. The Commonwealth expects that the effort to decrease expenses and the increase in tax revenue with the sales and use tax will eliminate or significantly lower the deficit in future years.

**COMMONWEALTH OF PUERTO RICO**

**Management's Discussion and Analysis (Unaudited)**

June 30, 2008

Business-type activities decreased the Commonwealth's net assets by \$33 million.

**Commonwealth of Puerto Rico's Changes in Net Assets (Deficit) – Primary Government**

Year ended June 30, 2008

(Expressed in thousands)

	<b>Governmental activities</b>	<b>Business-type activities</b>	<b>Total</b>
Revenue:			
Program revenue:			
Charges for services	\$ 664,505	1,161,084	1,825,589
Operating grants and contributions	4,311,592	77,803	4,389,395
Capital grants and contributions	137,916	—	137,916
	<u>5,114,013</u>	<u>1,238,887</u>	<u>6,352,900</u>
General revenue:			
Income taxes	5,493,881	—	5,493,881
Excise taxes	1,318,866	—	1,318,866
Sales and use tax	910,609	—	910,609
Other taxes	11,356	—	11,356
Revenue from component units	156,997	—	156,997
Special items	3,749,348	—	3,749,348
Other	580,563	35,423	615,986
	<u>12,221,620</u>	<u>35,423</u>	<u>12,257,043</u>
Total revenue	<u>17,335,633</u>	<u>1,274,310</u>	<u>18,609,943</u>
Expenses:			
General government	2,592,834	—	2,592,834
Public safety	2,161,265	—	2,161,265
Health	2,471,960	—	2,471,960
Public housing and welfare	3,194,945	—	3,194,945
Education	4,571,722	—	4,571,722
Economic development	471,640	—	471,640
Intergovernmental	474,023	—	474,023
Interest and other	1,086,906	28,738	1,115,644
Lotteries	—	699,005	699,005
Unemployment	—	269,924	269,924
Total expenses	<u>17,025,295</u>	<u>997,667</u>	<u>18,022,962</u>
Increase in net assets before transfers	310,338	276,643	586,981
Transfers	<u>309,815</u>	<u>(309,815)</u>	<u>—</u>
Increase (decrease) in net assets	620,153	(33,172)	586,981
Net assets (deficit), beginning of year (as restated)	<u>(18,435,483)</u>	<u>757,335</u>	<u>(17,678,148)</u>
Net assets (deficit), end of year	<u>\$ (17,815,330)</u>	<u>724,163</u>	<u>(17,091,167)</u>



**COMMONWEALTH OF PUERTO RICO**

Management's Discussion and Analysis (Unaudited)

June 30, 2008

**Commonwealth of Puerto Rico's Changes in Net Assets (Deficit) – Primary Government**

Year ended June 30, 2007

(Expressed in thousands)

	<b>Governmental activities</b>	<b>Business-type activities</b>	<b>Total</b>
Revenue:			
Program revenue:			
Charges for services	\$ 757,724	1,140,539	1,898,263
Operating grants and contributions	4,773,174	43,480	4,816,654
Capital grants and contributions	257,514	—	257,514
	<u>5,788,412</u>	<u>1,184,019</u>	<u>6,972,431</u>
General revenue:			
Income taxes	6,488,211	—	6,488,211
Excise taxes	1,475,311	—	1,475,311
Sales and use tax	583,639	—	583,639
Other taxes	4,663	—	4,663
Revenue from component units	381,336	—	381,336
Other	383,777	37,177	420,954
	<u>9,316,937</u>	<u>37,177</u>	<u>9,354,114</u>
Total revenue	<u>15,105,349</u>	<u>1,221,196</u>	<u>16,326,545</u>
Expenses:			
General government	2,847,596	—	2,847,596
Public safety	1,983,782	—	1,983,782
Health	1,943,582	—	1,943,582
Public housing and welfare	3,157,877	—	3,157,877
Education	4,748,008	—	4,748,008
Economic development	554,271	—	554,271
Intergovernmental	593,264	—	593,264
Interest and other	863,723	26,860	890,583
Lotteries	—	679,274	679,274
Unemployment	—	192,484	192,484
Total expenses	<u>16,692,103</u>	<u>898,618</u>	<u>17,590,721</u>
(Decrease) increase in net assets before transfers	(1,586,754)	322,578	(1,264,176)
Transfers	<u>342,743</u>	<u>(342,743)</u>	<u>—</u>
Decrease in net assets	<u>(1,244,011)</u>	<u>(20,165)</u>	<u>(1,264,176)</u>
Net assets (deficit), beginning of year (as restated)	<u>(17,194,883)</u>	<u>777,500</u>	<u>(16,417,383)</u>
Net assets (deficit), end of year	<u>\$ (18,438,894)</u>	<u>757,335</u>	<u>(17,681,559)</u>

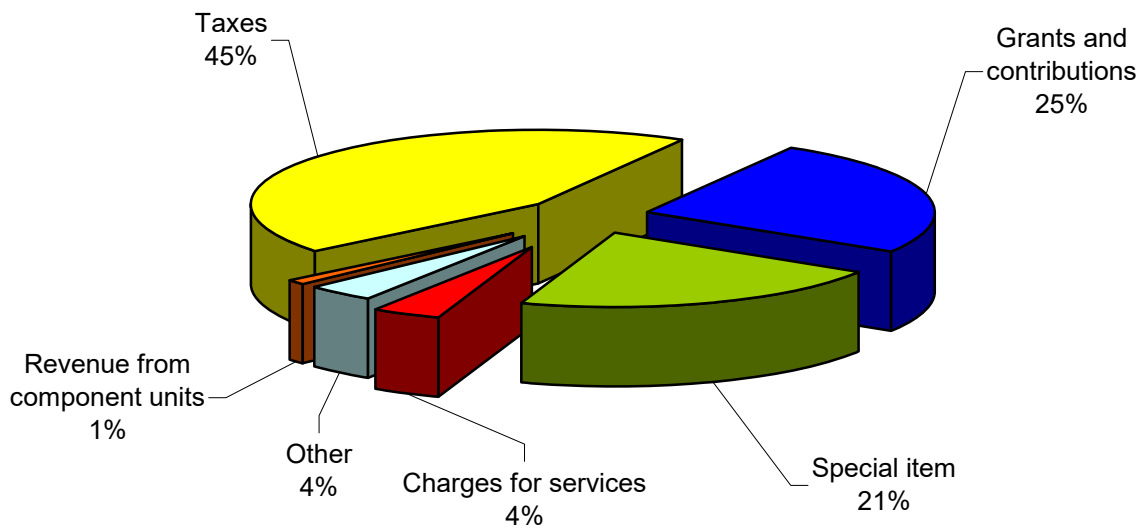
**COMMONWEALTH OF PUERTO RICO**

Management's Discussion and Analysis (Unaudited)

June 30, 2008

**Revenue – Governmental Activities**

Year ended June 30, 2008





## COMMONWEALTH OF PUERTO RICO

### Management's Discussion and Analysis (Unaudited)

June 30, 2008

#### Governmental Activities

Governmental activities decreased the Commonwealth's net deficit to \$17.8 billion. A comparison of the cost of services by function for the Commonwealth's governmental activities is shown below, along with the revenue used to cover the net expenses of the governmental activities (expressed in thousands).

#### Governmental Activities – Expenses Net of Program Revenue

Year ended June 30, 2008

(Expressed in thousands)

Net expense:	
General government	\$ (2,086,149)
Public safety	(2,010,544)
Health	(1,591,784)
Public housing and welfare	(959,673)
Education	(3,519,119)
Economic development	(183,084)
Intergovernmental	(474,023)
Interest and other	<u>(1,086,906)</u>
Total governmental activities expenses, net of program revenue	(11,911,282)
General revenue:	
Taxes	7,734,712
Revenue from component units	156,997
Special items	3,749,348
Transfers from business-type activities	309,815
Other revenue	<u>580,563</u>
Decrease in governmental activities' net deficit	<u><u>\$ 620,153</u></u>

#### *Business-Type Activities*

The business-type activities decreased the Commonwealth's net assets by \$33 million. This resulted from the increase of approximately \$10 million in contributions from federal government net of an increase of \$57 million in claims liability for insurance benefits when compared to prior year.

#### *Financial Analysis of the Commonwealth's Individual Funds*

As noted earlier, the Commonwealth uses fund accounting to help ensure and demonstrate compliance with finance-related legal requirements.

#### *Governmental Funds*

The focus of the Commonwealth's governmental funds is to provide information on near-term inflows, outflows, and balances of expendable resources. Such information is useful in assessing the Commonwealth's financing requirements. In particular, unreserved fund balance may serve as a useful measure of a government's net resources available for spending at the end of the fiscal year. As of the end of fiscal year 2008, the Commonwealth's governmental funds reported combined ending fund balance (deficit) of \$910 million, a

## COMMONWEALTH OF PUERTO RICO

### Management's Discussion and Analysis (Unaudited)

June 30, 2008

decrease of fund balance of \$1,021 million in comparison with the prior year. The expenditures exceeded the revenues by \$4.7 billion. However, this was offset by other financing sources amounting to \$3.7 billion in the fund balance of the governmental funds. This year, the excess of expenditures over revenue increased by \$2.8 billion compared with the prior year. Other, financing sources also increased by \$2.1 billion. There is \$735 million of fund balance reserved to indicate that it is not available for new spending because it has already been committed (1) to liquidate contracts and purchase orders of the prior fiscal year or (2) for a variety of other restricted purposes.

The general fund is the chief operating fund of the Commonwealth. At the end of the current fiscal year, unreserved fund deficit of the general fund was \$2.5 billion, while the total fund balance has a total deficit of \$1.8 billion. The fund deficit of the Commonwealth's general fund increased by \$1.3 billion as a result of the current fiscal year's change in financial position. This is a 249% increase when compared to total fund balance reported in fiscal year 2007. Also, see additional related comments in the following section titled general fund budgetary highlights.

The debt service fund is the fund in which the Commonwealth accumulates the resources for the payment of the long-term debt. At the end of the fiscal year, the fund balance of the debt service fund decreased by \$24 million when compared to prior year. Bonds and interest payable decreased by \$382 million or 95% when compared with the prior year mainly due to the early extinguishment and refinancing of debt.

The capital projects fund is used to account for the financial resources used by the primary government for the acquisition or construction of major capital facilities not being financed by other funds. The total fund balance at June 30, 2008 amounted to \$442 million. Cash and cash equivalents in commercial banks increased by \$104 million when compared to prior year primarily because of the proceeds from long-term debt issued during 2008.

The PBA capital projects fund received resources only from transfers from other funds amounting to \$208 million and had expenditures of \$85 million, which resulted in a \$123 million change in fund balance in 2008. The total fund balance at June 30, 2008 amounted to \$89 million. The fund's total assets increased \$121 million or 406% compared with the prior year because of a decrease in cash in commercial banks, which was used to acquire capital assets as well as an increase in other restricted assets.

The fund balance of The Children's Trust special revenue fund had a decrease of \$50 million. The decrease was mainly due to a reduction in revenues. Particular of fiscal year 2007, there were \$54 million of investments transferred from GDB related to QZAB bonds. No similar event occurred in the current year.

Revenue of other governmental funds (nonmajor) increased by \$11 million or 11% during the year compared with the prior year, the expenditures increased by \$21 million or 5%; the most significant increases in expenditures were noted in debt service of \$17 million. The funds had \$422 million in other financing sources, net of financing uses. All of the foregoing led to a net increase of \$107 million in the fund balance. Total assets of nonmajor funds decreased by \$26 million or 5% when compared with the prior year.

## **COMMONWEALTH OF PUERTO RICO**

### **Management's Discussion and Analysis (Unaudited)**

June 30, 2008

#### ***Proprietary Funds***

The Commonwealth's proprietary funds provide the same type of information found in the government-wide financial statements, but in more detail. As discussed in the business-type activities above, the Commonwealth's net assets decreased by \$33 million as a result of the operations in the proprietary funds. This resulted from a \$56 million increase in net assets by the other nonmajor proprietary fund, and a decrease in net assets of \$90 million by the unemployment insurance fund.

#### **General Fund Budgetary Highlights**

Actual revenues of \$8,207 million were not consistent with final budgeted revenues (\$8,667 million). Nonetheless, actual revenues were \$897 million less than originally budgeted (\$9,104 million). The reduction is primarily attributable to (i) decrease in the gross national product, as reported by the Puerto Rico Planning Board, from \$44.2 billion to \$43.1 billion, (ii) the substitution of the sales and use tax for the 5% general excise tax, and (iii) certain income tax rate reductions included in the tax reform legislation approved on July 2006. The major categories of income affected with the abovementioned factors were the excise taxes with a decrease of \$275 million, income taxes with a decrease of \$644 million, and charges for services with a decrease of \$31 million. These revenue reductions were offset by the increase in sales and use tax of \$328 million.

The actual expenditures reflected an increase of \$128 million when compared to the final budgeted amounts. The excess in expenditures was predominantly caused by the Social Economic Development Administration with \$25 million, the Corrections Administration with \$40 million, the Office of Management and Budget with \$20 million, the Puerto Rico General Count of Justice with \$15 million, and the Department of Health with \$16 million. Most of these variances were financed through the use of borrowings, approved by law or joint resolutions, from the Government Development Bank for Puerto Rico loans that provided resources of \$290 million.

## COMMONWEALTH OF PUERTO RICO

### Management's Discussion and Analysis (Unaudited)

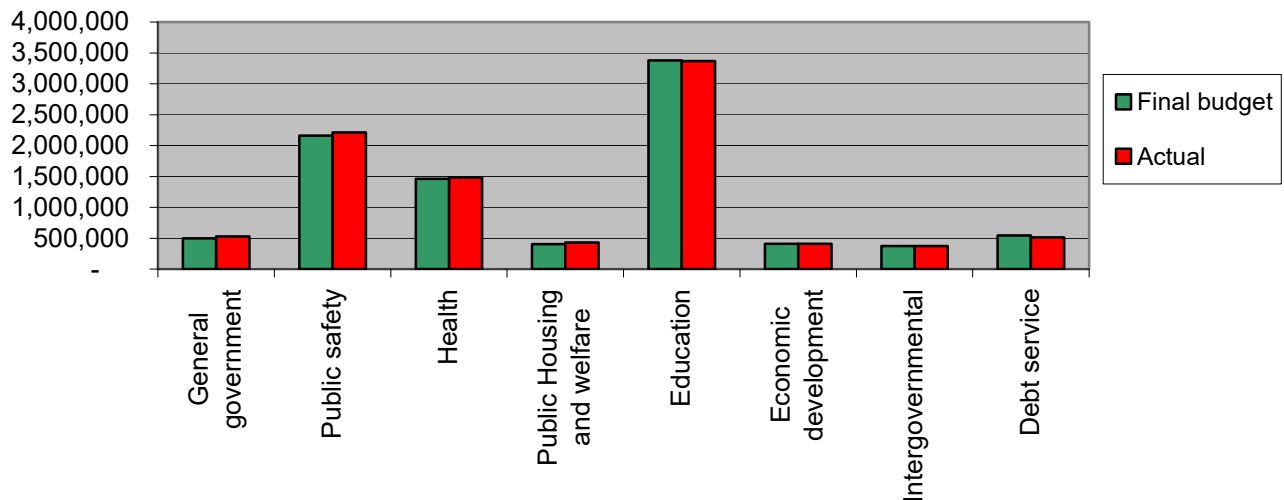
June 30, 2008

#### Expenditures – General Fund

##### Budget vs. Actual

Year ended June 30, 2008

(Expressed in thousands)



As of June 30, 2008, there was an excess of expenditures and other financing uses over revenue and other financing sources of \$674 million.

#### Capital Assets and Debt Administration

##### Capital Assets

The Commonwealth's investment in capital assets for its governmental and business-type activities as of June 30, 2008 amounts to \$10.5 billion, less accumulated depreciation of \$2.9 billion, leaving a book value of \$7.6 billion. This investment in capital assets includes land, buildings, building improvements, equipment, and construction in progress as infrastructure.

The net book value of capital assets at June 30, 2008 is distributed by function/activity in the following proportions: general government, 33%; public safety, 10%; health, 3%; public housing and welfare, 36%; education, 12%; and economic development, 6%. Actual capitalized assets were approximately \$429 million for the year. Depreciation charges for the year totaled \$244 million.

## COMMONWEALTH OF PUERTO RICO

### Management's Discussion and Analysis (Unaudited)

June 30, 2008

The infrastructure assets representing items that are normally immovable and of value only to the Commonwealth such as roads, highways, bridges, toll facilities, water and sewer systems, lighting production, transmission and distribution systems, and similar items are principally owned by the component units of the Commonwealth. Therefore, the infrastructure assets are reported within depreciable capital assets under the discretely presented component units column. Additional information on the Commonwealth's capital assets can be found in note 13 to the basic financial statements that accompany this report.

### Commonwealth's Capital Assets – Primary Government

June 30, 2008

(Expressed in thousands)

	<b>Governmental activities</b>	<b>Business-type activities</b>
Land	\$ 851,355	—
Construction in progress	1,471,916	—
Buildings and building improvements, net	4,673,654	—
Equipment, furniture, fixtures, and vehicles, net	222,676	674
Infrastructure, net	332,106	—
Total capital assets	<u>\$ 7,551,707</u>	<u>674</u>

### ***Debt Administration***

General obligation bonds are backed by the full faith and credit of the Commonwealth, including the Commonwealth's power to levy additional taxes to help ensure repayment of the debt.

The Constitution of the Commonwealth provides that direct obligations of the Commonwealth evidenced by bonds or notes and backed by the full faith, credit, and taxing power of the Commonwealth are not to be issued if the amount of the principal of, and interest on, such bonds and notes and on all such bonds and notes issued thereafter, which are payable in any fiscal year, together with any amount paid by the Commonwealth in the preceding fiscal year on account of bonds or notes guaranteed by the Commonwealth, exceed 15% of the average annual revenue raised under the provisions of Commonwealth legislation and conveyed into the treasury in the two fiscal years preceding the then-current fiscal year. Section 2, Article VI of the Constitution of the Commonwealth does not limit the amount of debt that the Commonwealth may guarantee as long as the 15% limitation is not exceeded. At June 30, 2008, the Commonwealth is in compliance with the debt limitation requirement.

On September 3, 2008, Moody's Investor Service, confirmed its "Baa3" rating of the Commonwealth general obligation debt, and its stable ratings outlook thereon. Also on that same day Standard & Poor's Rating Services (S&P) confirmed its "BBB-" ratings of the Commonwealth's general obligation and appropriation debt, and its stable outlook thereon.



**COMMONWEALTH OF PUERTO RICO**  
Management's Discussion and Analysis (Unaudited)

June 30, 2008

Ratings reflect only the respective views of the rating agencies and an explanation of the significance of each rating may be obtained only from the respective rating agency.

The Commonwealth's total long-term obligations decreased by \$1.3 billion during the current fiscal year, representing a 5.5% decrease. Additional information on the Commonwealth's long-term obligations can be found in note 15 to the basic financial statements of this report.

**Economic Factors and Next Year's Budgets and Rates**

The average unemployment rate for the Commonwealth in 2008 was 11.0%, an increase of 5.77% from the 2007 average rate of 10.4%. In terms of production, the real gross national product registered a decrease of 2.49%.

Based on the projections of the Puerto Rico Planning Board, the Puerto Rico economy is expected to reflect another decrease of 3.4% for the fiscal year 2009.

The consolidated budget for the fiscal year 2007 – 08 amounts to \$27.5 billion. From this amount, \$21.4 billion is assigned to operating expenses, \$3.1 billion to a permanent capital improvements program, and \$3 billion for the debt service. For fiscal year 2008 – 09, the figures are: consolidated budget of \$27.4 billion, of which \$22.1 billion are assigned to operating expenses, \$2.5 billion to the capital improvements program, and \$2.8 billion to debt service.

**Requests for Information**

This financial report is designed to provide a general overview of the Commonwealth's finances for all of the Commonwealth's residents, taxpayers, customers, investors, and creditors. This financial report seeks to demonstrate the Commonwealth's accountability for the money it receives. Questions concerning any of the information provided in this report or requests for additional information should be addressed to: Department of the Treasury of the Commonwealth of Puerto Rico, Área de Contabilidad Central, P.O. Box 9024140, San Juan, PR 00902-4140.

**COMMONWEALTH OF PUERTO RICO**

Statement of Net Assets (Deficit)

June 30, 2008

(In thousands)

	Primary government			Component units
	Governmental activities	Business- type activities	Totals primary government	
Assets:				
Cash and cash equivalents in commercial banks	\$ 153,285	129,466	282,751	2,184,724
Cash and cash equivalents in governmental banks	354,197	585,259	939,456	706,324
Investments	158,725	—	158,725	4,087,613
Receivables, net of allowance for uncollectibles:				
Taxes	1,265,616	—	1,265,616	—
Unemployment and other insurance premiums	—	56,366	56,366	130,538
Intergovernmental	264,516	—	264,516	34,483
Accounts	127,554	—	127,554	968,234
Loans	6,863	—	6,863	3,965,207
Accrued interest	31,964	3,591	35,555	302,080
Other	118,369	16,592	134,961	340,370
Due from:				
Primary government	—	—	—	348,833
Component units	125,408	10,084	135,492	796,230
Other governmental entities	227	—	227	361,852
Internal balances	(4,038)	4,038	—	—
Inventories	37,774	—	37,774	466,447
Prepaid expenses	19,402	—	19,402	33,971
Other assets	20,938	—	20,938	—
Restricted assets:				
Cash and cash equivalents in commercial banks	620,170	—	620,170	818,398
Cash and cash equivalents in governmental banks	1,128,094	—	1,128,094	1,073,338
Investments and other restricted assets	143,260	34,637	177,897	7,175,993
Long-term investments	—	—	—	1,756,967
Long-term receivables from:				
Loans	—	—	—	158,605
Other	—	—	—	3,106
Long-term amounts due from:				
Primary government	—	—	—	89,200
Component units	4,543	283,206	287,749	895,190
Other governmental entities	—	—	—	55,096
Real estate held for sale or future development	57,936	—	57,936	252,102
Deferred expenses and other assets	272,365	40,382	312,747	817,939
Capital assets (net of accumulated depreciation):				
Land and other nondepreciable assets	2,323,271	—	2,323,271	9,920,190
Depreciable assets	5,228,436	674	5,229,110	19,256,406
Total assets	12,458,875	1,164,295	13,623,170	56,999,436

**COMMONWEALTH OF PUERTO RICO**

Statement of Net Assets (Deficit)

June 30, 2008

(In thousands)

	Primary government			Component units
	Governmental activities	Business- type activities	Totals primary government	
Liabilities:				
Accounts payable and accrued liabilities	\$ 1,823,690	6,114	1,829,804	2,687,968
Deposits and escrow liabilities	—	—	—	7,763,004
Tax refunds payable	244,994	—	244,994	—
Due to:				
Primary government	—	—	—	135,492
Component units	438,033	—	438,033	796,230
Other governmental entities	303	—	303	19,749
Securities lending transactions and reverse repurchase agreements	—	—	—	890,139
Interest payable	137,444	—	137,444	576,099
Deferred revenue	280,707	25,504	306,211	125,845
Tax revenue anticipation notes payable	1,010,000	—	1,010,000	—
Due to primary government – long-term portion	—	—	—	287,749
Due to component units – long-term portion	—	—	—	895,190
Deferred revenue – long-term portion	—	—	—	18,763
Insurance benefits payable	—	114,575	114,575	—
Liability for automobile accident insurance and workmen compensation claims	—	—	—	817,440
Liabilities payable within one year:				
Commonwealth appropriation bonds	—	—	—	9,926
Bonds	90,245	—	90,245	652,582
Notes	526,792	—	526,792	1,455,823
Capital leases	4,570	—	4,570	—
Compensated absences	1,054,674	2,486	1,057,160	257,430
Lottery prizes	—	67,650	67,650	—
Other long-term liabilities	126,946	—	126,946	114,499
Liabilities payable after one year:				
Commonwealth appropriation bonds	829,327	—	829,327	895,370
Bonds	13,901,192	—	13,901,192	27,335,448
Notes	1,618,107	—	1,618,107	2,453,067
Capital leases	176,253	—	176,253	—
Net pension obligation	5,843,431	—	5,843,431	—
Net postemployment benefit obligation	42,373	—	42,373	—
Compensated absences	713,849	3,725	717,574	349,301
Lottery prizes	—	220,078	220,078	—
Other long-term liabilities	1,411,275	—	1,411,275	628,099
Total liabilities	30,274,205	440,132	30,714,337	49,165,213
Net assets (deficit):				
Invested in capital assets, net of related debt	3,979,308	674	3,979,982	10,534,312
Restricted for:				
Trust – nonexpendable	—	—	—	1,544,451
Capital projects	293,828	—	293,828	750,563
Debt service	99,042	—	99,042	806,931
Payment of insurance benefits	—	33,803	33,803	—
Affordable housing and related loan insurance programs	328,651	—	328,651	568,473
Student loans and other educational purposes	—	—	—	70,966
Other	—	—	—	294,648
Unrestricted deficit	(22,516,159)	689,686	(21,826,473)	(6,736,121)
Total net assets (deficit)	\$ (17,815,330)	724,163	(17,091,167)	7,834,223

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Statement of Activities

Year ended June 30, 2008

(In thousands)

Functions	Expenses	Program revenue			Net (expense) revenue and changes in net assets			Component units
		Charges for services	Operating grants and contributions	Capital grants and contributions	Governmental activities	Primary government Business-type activities	Total	
Primary government:								
Governmental activities:								
Current:								
General government	\$ 2,592,834	338,839	167,846	—	(2,086,149)	—	(2,086,149)	—
Public safety	2,161,265	74,161	74,760	1,800	(2,010,544)	—	(2,010,544)	—
Health	2,471,960	145,580	734,551	45	(1,591,784)	—	(1,591,784)	—
Public housing and welfare	3,194,945	31,677	2,067,324	136,071	(959,673)	—	(959,673)	—
Education	4,571,722	3,004	1,049,599	—	(3,519,119)	—	(3,519,119)	—
Economic development	471,640	71,244	217,312	—	(183,084)	—	(183,084)	—
Intergovernmental	474,023	—	—	—	(474,023)	—	(474,023)	—
Interest and other	1,086,906	—	—	—	(1,086,906)	—	(1,086,906)	—
Total governmental activities	17,025,295	664,505	4,311,592	137,916	(11,911,282)	—	(11,911,282)	—
Business-type activities:								
Unemployment insurance	269,924	235,918	20,365	—	—	(13,641)	(13,641)	—
Lotteries	699,005	897,898	—	—	—	198,893	198,893	—
Other	28,738	27,268	57,438	—	—	55,968	55,968	—
Total business-type activities	997,667	1,161,084	77,803	—	—	241,220	241,220	—
Total primary government	\$ 18,022,962	1,825,589	4,389,395	137,916	(11,911,282)	241,220	(11,670,062)	—
Component units:								
Government Development Bank for Puerto Rico	\$ 682,067	636,538	—	115,588	—	—	—	70,059
Puerto Rico Highway and Transportation Authority	1,030,586	273,591	—	158,784	—	—	—	(598,211)
Puerto Rico Electric Power Authority	4,711,791	4,362,209	—	—	—	—	—	(349,582)
Puerto Rico Aqueduct and Sewer Authority	1,033,399	695,735	34,023	—	—	—	—	(303,641)
Puerto Rico Infrastructure Financing Authority	214,659	—	—	—	—	—	—	(214,659)
University of Puerto Rico	1,418,033	171,996	141,734	—	—	—	—	(1,104,303)
Puerto Rico Sales Tax Financing Corporation	227,555	—	—	—	—	—	—	(227,555)
Puerto Rico Health Insurance Administration	1,735,504	593,886	—	—	—	—	—	(1,141,618)
Other component units	2,869,402	1,872,055	65,851	102,006	—	—	—	(829,490)
Total component units	\$ 13,922,996	8,606,010	241,608	376,378	—	—	—	(4,699,000)
General revenue:								
Taxes:								
Income taxes					\$ 5,493,881	—	5,493,881	—
Excise taxes					1,318,866	—	1,318,866	358,059
Sales and use tax					910,609	—	910,609	206,271
Other taxes					11,356	—	11,356	—
Revenue from global tobacco settlement agreement					82,608	—	82,608	—
Revenue from State Insurance Fund Corporation					41,388	—	41,388	—
Revenue from Puerto Rico Tourism Company					23,492	—	23,492	—
Revenue from Governing Board of 9-1-1 Services					9,509	—	9,509	—
Grants and contributions not restricted to specific programs					120,006	—	120,006	178,397
Special items payment of debt by Puerto Rico Sales Tax Financing Corporation					3,749,348	—	3,749,348	(4,502,746)
Payments from primary government					160,926	35,423	196,349	2,460,421
Unrestricted investment earnings					299,631	—	299,631	520,700
Other					309,815	(309,815)	—	100,103
Transfers					—	—	—	—
Total general revenue and transfers					12,531,435	(274,392)	12,257,043	(678,795)
Change in net assets (deficit)					620,153	(33,172)	586,981	(5,377,795)
Net assets (deficit) – beginning of year (as restated)					(18,435,483)	757,335	(17,678,148)	13,212,018
Net assets (deficit) – end of year					\$ (17,815,330)	724,163	(17,091,167)	7,834,223

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Balance Sheet -- Governmental Funds

June 30, 2008

(In thousands)

Assets	General	Debt service	Capital projects	PBA capital projects	The Children's Trust special revenue	Other governmental	Totals governmental
Cash and cash equivalents in commercial banks	\$ —	2,830	137,648	—	—	12,807	153,285
Cash and cash equivalents in governmental banks	—	5,225	303,412	—	28,293	17,267	354,197
Investments	—	—	—	—	44,858	113,867	158,725
Receivables, net of allowance for uncollectibles:							
Taxes	1,265,616	—	—	—	—	—	1,265,616
Intergovernmental	239,566	24,950	—	—	—	—	264,516
Accounts	118,876	—	671	—	—	8,007	127,554
Loans	6,827	—	36	—	—	—	6,863
Accrued interest	31,030	451	—	—	39	444	31,964
Due from:							
Other funds	71,386	—	32,167	—	—	183,158	286,711
Component units	129,951	—	—	—	—	—	129,951
Other governmental entities	—	—	—	—	—	227	227
Restricted assets:							
Cash and cash equivalents in commercial banks	398,233	—	—	150,568	—	71,369	620,170
Cash and cash equivalents in governmental banks	1,073,916	—	—	—	—	54,178	1,128,094
Other restricted assets	143,260	—	—	—	—	—	143,260
Other assets	20,938	—	—	—	—	—	20,938
Real estate held for future development and other assets	41,167	—	1,853	—	—	14,916	57,936
Total assets	\$ 3,540,766	33,456	475,787	150,568	73,190	476,240	4,750,007



COMMONWEALTH OF PUERTO RICO

Balance Sheet -- Governmental Funds

June 30, 2008

(In thousands)

Liabilities and Fund Balances (Deficit)	General	Debt service	Capital projects	PBA capital projects	The Children's Trust special revenue	Other governmental	Totals governmental
<b>Liabilities:</b>							
Accounts payable and accrued liabilities	\$ 1,716,100	8,923	33,424	46,924	1,986	48,208	1,855,565
Tax refunds payable	244,994	—	—	—	—	—	244,994
Due to:							
Other funds	275,749	—	—	15,000	—	—	290,749
Other governmental entities	303	—	—	—	—	—	303
Component units	398,768	—	—	—	—	39,265	438,033
Notes payable	354,186	—	—	—	—	—	354,186
Bonds payable	—	2,275	—	—	—	52,505	54,780
Interest payable	56,407	18,446	—	—	—	81,536	156,389
Deferred revenue	1,255,144	—	—	—	—	—	1,255,144
Tax revenue anticipation notes payable	1,010,000	—	—	—	—	—	1,010,000
<b>Total liabilities</b>	<b>5,311,651</b>	<b>29,644</b>	<b>33,424</b>	<b>61,924</b>	<b>1,986</b>	<b>221,514</b>	<b>5,660,143</b>
<b>Fund balances (deficit):</b>							
Reserved for:							
Encumbrances	334,524	—	10,431	—	—	—	344,955
Capital projects	13,730	—	—	—	—	—	13,730
Assets in liquidation	77,091	—	—	—	—	—	77,091
Low-income housing assistance	298,289	—	—	—	—	—	298,289
Other specified purposes	—	—	—	—	—	1,236	1,236
Unreserved (deficit):							
General fund	(2,494,519)	—	—	—	—	—	(2,494,519)
Debt service funds	—	3,812	—	—	—	123,764	127,576
Special revenue funds	—	—	—	—	71,204	129,726	200,930
Capital project funds	—	—	431,932	88,644	—	—	520,576
<b>Total fund balances (deficit)</b>	<b>(1,770,885)</b>	<b>3,812</b>	<b>442,363</b>	<b>88,644</b>	<b>71,204</b>	<b>254,726</b>	<b>(910,136)</b>
<b>Total liabilities and fund balances (deficit)</b>	<b>\$ 3,540,766</b>	<b>33,456</b>	<b>475,787</b>	<b>150,568</b>	<b>73,190</b>	<b>476,240</b>	<b>4,750,007</b>

See accompanying notes to basic financial statements.

**COMMONWEALTH OF PUERTO RICO**

Reconciliation of the Balance Sheet to the Statement of Net Assets (Deficit) – Governmental Funds

June 30, 2008

(In thousands)

Amounts reported for governmental activities in the statement of net assets (deficit) are different than the amounts reported in the governmental funds because:

Total fund balance of governmental funds	\$ (910,136)
Accounts receivable for the global tobacco settlement agreement and PBA	118,369
Inventories and prepaid expenses that are not reported in governmental funds and are reported in statement of net assets	57,176
Capital assets used in governmental activities are not financial resources and therefore are not reported in the funds	7,551,707
Deferred revenue for governmental funds that are recorded as revenue in the statement of net assets	974,437
Debt issued by the Commonwealth have associated costs that are paid from current available resources in the funds. However, these costs are deferred on the statement of net assets.	272,365
Liabilities, including Commonwealth accounts payable of \$31,890, appropriation bonds of \$(829,327) bonds payable of \$(13,936,672), notes payable of \$(1,790,713), capital leases payable of \$(180,823), compensated absences of \$(1,768,523), net pension obligation of \$(5,843,431), net postemployment benefit obligation of \$(42,373), interest payable of \$18,945, and other long-term liabilities of \$(1,538,221) are not due and payable in the current period and therefore are not reported in the funds	<u>(25,879,248)</u>
Total net deficit of governmental activities	<u>\$ (17,815,330)</u>

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO

Statement of Revenue, Expenditures, and Changes in Fund Balances (Deficit) --  
Governmental Funds

Year ended June 30, 2008

(In thousands)

	General	Debt service	Capital projects	PBA capital projects	The Children's Trust special revenue	Other governmental	Totals governmental
<b>Revenue:</b>							
Taxes:							
Income taxes	\$ 5,493,881	—	—	—	—	—	5,493,881
Excise taxes	1,306,416	—	—	—	—	—	1,306,416
Sales and use tax	910,609	—	—	—	—	—	910,609
Other taxes	11,356	—	—	—	—	—	11,356
Charges for services	664,505	—	—	—	—	—	664,505
Revenue from global tobacco settlement agreement	—	—	—	—	—	82,608	82,608
Revenues from component units:							
State Insurance Fund Corporation	41,388	—	—	—	—	—	41,388
Tourism Company of Puerto Rico	23,492	—	—	—	—	—	23,492
Governing Board of 9-1-1 Services	9,509	—	—	—	—	—	9,509
Intergovernmental	4,419,109	120,006	22,372	—	—	7,970	4,569,457
Interest and investment earnings	66,894	80,340	—	—	4,211	9,481	160,926
Other	183,886	100,018	—	—	—	14,538	298,442
<b>Total revenue</b>	<b>13,131,045</b>	<b>300,364</b>	<b>22,372</b>	<b>—</b>	<b>4,211</b>	<b>114,597</b>	<b>13,572,589</b>
<b>Expenditures:</b>							
Current:							
General government	1,568,296	—	50,624	—	—	150,578	1,769,498
Public safety	2,104,343	—	30,576	—	—	—	2,134,919
Health	2,345,115	—	—	—	535	—	2,345,650
Public housing and welfare	3,086,489	—	12,195	—	—	—	3,098,684
Education	4,419,176	—	5,080	—	8,624	—	4,432,880
Economic development	383,483	—	31,468	—	1,025	—	415,976
Intergovernmental	368,837	—	98,882	—	2,676	—	470,395
Capital outlay	222,865	—	120,939	85,434	—	—	429,238
Debt service:							
Principal	1,938,098	2,275	—	—	143,000	80,331	2,163,704
Interest	339,291	325,558	—	—	3,478	185,925	854,252
Other – SWAPS	—	100,033	—	—	—	—	100,033
Other – debt issuance costs	—	67,448	1,564	—	701	13,138	82,851
<b>Total expenditures</b>	<b>16,775,993</b>	<b>495,314</b>	<b>351,328</b>	<b>85,434</b>	<b>160,039</b>	<b>429,972</b>	<b>18,298,080</b>
<b>Excess (deficiency) of revenues over expenditures</b>	<b>(3,644,948)</b>	<b>(194,950)</b>	<b>(328,956)</b>	<b>(85,434)</b>	<b>(155,828)</b>	<b>(315,375)</b>	<b>(4,725,491)</b>
<b>Other financing sources (uses):</b>							
Transfers in	642,976	242,236	—	208,300	243	211,285	1,305,040
Transfers out	(555,653)	—	(131,637)	—	(190,000)	(117,935)	(995,225)
Long-term debt issued	194,602	—	534,592	—	296,879	895,290	1,921,363
Bond issue discount	—	—	—	—	(1,424)	(2,636)	(4,060)
Capital leases	43,850	—	—	—	—	—	43,850
Refunding bonds issued	—	2,086,240	—	—	—	—	2,086,240
Bond proceeds – premium	—	40,613	12,978	—	—	52,516	106,107
Payment of debt by Puerto Rico Sales Tax Financing Corporation	3,749,348	—	—	—	—	—	3,749,348
Payment to escrow agent	(1,693,313)	(2,198,362)	—	—	—	(616,153)	(4,507,828)
<b>Total other financing sources (uses)</b>	<b>2,381,810</b>	<b>170,727</b>	<b>415,933</b>	<b>208,300</b>	<b>105,698</b>	<b>422,367</b>	<b>3,704,835</b>
<b>Net change in fund balances (deficit)</b>	<b>(1,263,138)</b>	<b>(24,223)</b>	<b>86,977</b>	<b>122,866</b>	<b>(50,130)</b>	<b>106,992</b>	<b>(1,020,656)</b>
<b>Fund balances (deficit) at beginning of year (as restated)</b>	<b>(507,747)</b>	<b>28,035</b>	<b>355,386</b>	<b>(34,222)</b>	<b>121,334</b>	<b>147,734</b>	<b>110,520</b>
<b>Fund balances (deficit) at end of year</b>	<b>\$ (1,770,885)</b>	<b>3,812</b>	<b>442,363</b>	<b>88,644</b>	<b>71,204</b>	<b>254,726</b>	<b>(910,136)</b>

See accompanying notes to basic financial statements.

**COMMONWEALTH OF PUERTO RICO**

**Reconciliation of the Statement of Revenue, Expenditures, and Changes in Fund Balances (Deficit)  
to the Statement of Activities – Governmental Funds**

**Year ended June 30, 2008**

**(In thousands)**

Net change in fund balances (deficit) – total governmental funds	\$ (1,020,656)
Governmental funds report capital outlays as expenditures. However, in the statement of activities, the cost of those assets is allocated over their estimated useful lives as depreciation expense. This is the amount by which capital outlays \$429,338 exceeded depreciation of \$(243,627) in the current period	185,711
Debt proceeds provide current financial resources to governmental funds, but issuing debt increases long-term liabilities in the statement of net assets. Repayment of bond principal is an expenditure in the governmental funds, but the repayment reduces long-term liabilities in the statement of net assets. This is the amount by which payments of \$6,671,532 exceeded proceeds of \$4,153,500	2,518,032
Certain interest and other costs reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in the governmental funds. Net accretion and amortization of capital appreciation bonds, debt issue premium, debt issue costs, and deferred charges	(132,428)
Bond issuance costs are expenditures in governmental funds, but are deferred assets in the statement of net assets	82,851
Revenue from Global settlement agreement not due in current period and therefore not recorded in funds	1,190
Excise tax revenue not due in the current period and therefore not recorded in funds	12,450
Some expenses reported in the statement of activities do not require the use of current financial resources and therefore are not reported as expenditures in the governmental funds. This is the amount by which other long-term liabilities and accrued interest expense decreased	(1,038,650)
Generally, inventory and prepayments are recorded as expenditures in the governmental funds when purchased rather than capitalized as an asset. However, these assets are capitalized in the statement of net assets.	11,653
Change in net assets of governmental activities	<u>\$ 620,153</u>

See accompanying notes to basic financial statements.

**COMMONWEALTH OF PUERTO RICO**

**Statement of Revenue and Expenditures – Budget and Actual –  
Budget Basis – General Fund**

Year ended June 30, 2008

(In thousands)

	<b>Original budget</b>	<b>Amended budget</b>	<b>Actual</b>	<b>Variance</b>
<b>Revenue:</b>				
Income taxes	\$ 6,287,000	5,928,000	5,509,600	(418,400)
Excise taxes	1,276,000	1,220,000	1,196,908	(23,092)
Other taxes	111,000	100,000	94,290	(5,710)
Sales and use taxes	911,000	911,000	911,000	—
Charge for services	221,000	184,000	168,247	(15,753)
Intergovernmental	14,000	5,000	4,846	(154)
Revenues from component units	174,000	174,000	168,699	(5,301)
Other	110,000	145,000	153,507	8,507
<b>Total revenue</b>	<b>9,104,000</b>	<b>8,667,000</b>	<b>8,207,097</b>	<b>(459,903)</b>
<b>Expenditures:</b>				
<b>Current:</b>				
General government	514,773	495,689	530,123	(34,434)
Public safety	2,134,322	2,161,517	2,212,373	(50,856)
Health	1,393,959	1,463,135	1,484,038	(20,903)
Public housing and welfare	368,375	402,002	430,125	(28,123)
Education	3,342,245	3,377,110	3,369,947	7,163
Economic development	347,953	410,769	407,866	2,903
Intergovernmental	356,267	371,186	374,777	(3,591)
<b>Total expenditures</b>	<b>8,457,894</b>	<b>8,681,408</b>	<b>8,809,249</b>	<b>(127,841)</b>
<b>Excess (deficiency) of revenue over (under) expenditures</b>	<b>646,106</b>	<b>(14,408)</b>	<b>(602,152)</b>	<b>(587,744)</b>
<b>Other financing sources (uses):</b>				
Notes payable issued	—	—	290,303	290,303
Transfer in	123,000	154,000	151,934	(2,066)
Transfer out	(769,106)	(545,592)	(514,492)	31,100
<b>Total other financing sources (uses)</b>	<b>(646,106)</b>	<b>(391,592)</b>	<b>(72,255)</b>	<b>319,337</b>
<b>Excess of expenditures and other financing uses over revenue and other financing sources</b>	<b>\$ —</b>	<b>(406,000)</b>	<b>(674,407)</b>	<b>(268,407)</b>

See accompanying notes to basic financial statements.



**COMMONWEALTH OF PUERTO RICO**

Statement of Net Assets (Deficit) – Proprietary Funds

June 30, 2008

(In thousands)

Assets	Business-type activities – Enterprise funds			
	Unemployment insurance	Lotteries	Other proprietary	Totals proprietary
Current assets:				
Cash and cash equivalents in commercial banks	\$ —	16,169	113,297	129,466
Cash and cash equivalents in governmental banks	444,506	78,169	62,584	585,259
Insurance premiums, net	51,372	—	4,994	56,366
Due from component units	—	—	10,084	10,084
Accrued interest	541	—	3,050	3,591
Other receivables	8,301	7,937	354	16,592
Total current assets	504,720	102,275	194,363	801,358
Noncurrent assets:				
Loans receivable from component units	—	—	283,206	283,206
Due from other funds	—	60,424	—	60,424
Capital assets, net	—	674	—	674
Restricted investments	—	—	34,637	34,637
Other	—	38,784	1,598	40,382
Total assets	\$ 504,720	202,157	513,804	1,220,681
<b>Liabilities and Net Assets (Deficit)</b>				
Current liabilities:				
Accounts payable and accrued liabilities	\$ —	3,974	2,140	6,114
Due to other funds	13,632	42,754	—	56,386
Deferred revenue	8,695	16,790	19	25,504
Compensated absences	—	2,486	—	2,486
Lottery awards	—	67,650	—	67,650
Insurance benefits payable	113,391	—	1,184	114,575
Total current liabilities	135,718	133,654	3,343	272,715
Noncurrent liabilities:				
Lottery awards, excluding current portion	—	220,078	—	220,078
Compensated absences, excluding current portion	—	1,569	2,156	3,725
Total liabilities	135,718	355,301	5,499	496,518
Net assets (deficit):				
Invested in capital assets, net of related debt	—	674	—	674
Restricted for:				
Payment of insurance benefits	—	—	33,803	33,803
Unrestricted	369,002	(153,818)	474,502	689,686
Total net assets (deficit)	\$ 369,002	(153,144)	508,305	724,163

See accompanying notes to basic financial statements.

**COMMONWEALTH OF PUERTO RICO**

Statement of Revenue, Expenses and Changes in Net Assets (Deficit)  
– Proprietary Funds

Year ended June 30, 2008

(In thousands)

	<b>Business-type activities – Enterprise funds</b>			
	<b>Unemployment insurance</b>	<b>Lotteries</b>	<b>Other proprietary</b>	<b>Total proprietary</b>
Operating revenues:				
Insurance premiums	\$ 235,918	—	19,793	255,711
Lottery ticket sales	—	897,847	—	897,847
Interest	—	—	7,475	7,475
Other	—	51	—	51
Total operating revenues	235,918	897,898	27,268	1,161,084
Operating expenses:				
Insurance benefits	269,924	—	4,298	274,222
Lottery awards	—	560,525	—	560,525
General, administrative, and other operating expenses	—	138,480	24,440	162,920
Total operating expenses	269,924	699,005	28,738	997,667
Operating income (loss)	(34,006)	198,893	(1,470)	163,417
Nonoperating revenue:				
Contributions from U.S. government	20,365	—	57,438	77,803
Interest and investment earnings	27,204	6,295	1,924	35,423
Total nonoperating revenue	47,569	6,295	59,362	113,226
Income before transfers	13,563	205,188	57,892	276,643
Transfers from other funds	12,800	—	11,524	24,324
Transfers to other funds	(116,151)	(205,188)	(12,800)	(334,139)
Net change in net assets (deficit)	(89,788)	—	56,616	(33,172)
Net assets (deficit) at beginning of year	458,790	(153,144)	451,689	757,335
Net assets (deficit) at end of year	\$ 369,002	(153,144)	508,305	724,163

See accompanying notes to basic financial statements.

**COMMONWEALTH OF PUERTO RICO**

Statement of Cash Flows– Proprietary Funds

Year ended June 30, 2008

(In thousands)

	Business-type activities – Enterprise funds			
	Unemployment insurance	Lotteries	Other proprietary	Totals proprietary
Cash flows from operating activities:				
Receipts from customers and users	\$ 238,830	904,656	19,386	1,162,872
Other receipts	14,260	51	16,439	30,750
Payments to suppliers	—	(130,421)	(14,215)	(144,636)
Payment to employees	—	(8,763)	(9,217)	(17,980)
Payment of lottery prizes	—	(567,908)	—	(567,908)
Payments of insurance benefits	(214,775)	—	(4,248)	(219,023)
Other payments	—	—	(74,683)	(74,683)
Net cash provided by (used in) operating activities	38,315	197,615	(66,538)	169,392
Cash flows from noncapital financing activities:				
Intergovernmental grants and contributions	20,365	—	57,438	77,803
Transfers from other funds	12,800	—	11,524	24,324
Transfers to other funds	(116,151)	(236,335)	(12,800)	(365,286)
Net cash provided by (used in) noncapital financing activities	(82,986)	(236,335)	56,162	(263,159)
Cash flows from investing activities:				
Interest received on deposits and investments	27,232	6,295	2,992	36,519
Net cash provided by investing activities	27,232	6,295	2,992	36,519
Net decrease in cash and cash equivalents	(17,439)	(32,425)	(7,384)	(57,248)
Cash and equivalents at beginning of year	461,945	126,763	183,265	771,973
Cash and cash equivalents at end of year	\$ 444,506	94,338	175,881	714,725
Reconciliation of operating income (loss) to net cash provided by (used in) operating activities:				
Operating income (loss)	\$ (34,006)	198,893	(1,470)	163,417
Adjustments to reconcile operating income (loss) to net cash provided by (used in) operating activities:				
Interests earned on deposits, loans and investments	—	—	(658)	(658)
Changes in operating assets and liabilities:				
Decrease (increase) in accounts and loans receivable	3,540	(2,494)	(64,112)	(63,066)
Decrease (increase) in other assets	—	(217)	(217)	(434)
Decrease in accounts payable and accrued liabilities	—	(711)	(391)	(1,102)
Decrease in obligation for unpaid lottery awards	—	(4,562)	—	(4,562)
Increase in due to (from) other funds	13,632	6,633	—	20,265
Increase (decrease) in deferred revenues	(1,461)	74	(9)	(1,396)
Increase (decrease) in compensated absences	—	(1)	269	268
Increase in liability for insurance benefits payable	56,610	—	50	56,660
Total adjustments	72,321	(1,278)	(65,068)	5,975
Net cash provided by (used in) operating activities	\$ 38,315	197,615	(66,538)	169,392

See accompanying notes to basic financial statements.

**COMMONWEALTH OF PUERTO RICO**

Statement of Fiduciary Net Assets

June 30, 2008

(In thousands)

<b>Assets</b>	<b>Pension trust</b>	<b>Special deposits- agency</b>
Cash and cash equivalents in commercial banks and U.S. Treasury:		
Unrestricted	\$ 333,273	632,476
Cash and cash equivalents in governmental banks:		
Unrestricted	80,792	677,515
Restricted	1,320,224	—
Investments:		
Debt and equity securities, at fair value	4,935,874	—
Other	79,924	41,402
Receivables, net:		
Accounts	278,228	—
Loans and advances	1,303,903	—
Accrued interest and dividends	9,673	—
Other	73,351	—
Capital assets, net	36,063	—
Other assets	44,206	—
Total assets	<u>8,495,511</u>	<u>1,351,393</u>
<b>Liabilities</b>		
Accounts payable and accrued liabilities	59,584	1,351,393
Other liabilities	32,000	—
Bonds payable	2,942,184	—
Total liabilities	<u>3,033,768</u>	<u>1,351,393</u>
<b>Net Assets</b>		
Net assets held in trust for pension and other benefits	\$ <u>5,461,743</u>	<u>—</u>

See accompanying notes to basic financial statements.

**COMMONWEALTH OF PUERTO RICO**

Statement of Changes in Fiduciary Net Assets – Pension Trust Funds

Year ended June 30, 2008

(In thousands)

Additions:		
Contributions:		
Sponsor	\$	504,603
Participants		476,256
Special		230,779
Total contributions		<u>1,211,638</u>
Interest income and investment loss:		
Interest		185,141
Dividends		26,243
Net change in fair value of investments		(497,886)
Investment expenses		<u>(13,708)</u>
Net interest income and investment loss		<u>(300,210)</u>
Other income		<u>32,742</u>
Total additions		<u>944,170</u>
Deductions:		
Pension and other benefits		1,446,697
Refunds of contributions		46,962
General and administrative		<u>124,462</u>
Total deductions		<u>1,618,121</u>
Net change in net assets held in trust for pension and other benefits		<u>(673,951)</u>
Net assets held in trust for pension and other benefits:		
Beginning of year		<u>6,135,694</u>
End of year	\$	<u><u>5,461,743</u></u>

See accompanying notes to basic financial statements.



COMMONWEALTH OF PUERTO RICO  
Combining Statement of Net Assets (Deficit)- Major Component Units

June 30, 2008

(In thousands)

Assets	Major component units										
	Government Development Bank for Puerto Rico	Puerto Rico Highways and Transportation Authority	Puerto Rico Electric Power Authority	Puerto Rico Aqueduct and Sewer Authority	Puerto Rico Infrastructure Financing Authority	University of Puerto Rico	Puerto Rico Sales Tax Financing Corporation	Puerto Rico Health Insurance Administration	Major component unit totals	Nonmajor component unit totals	All component unit totals
Current assets:											
Cash and cash equivalents in commercial banks	\$ 1,910,720	30,584	40,920	521	—	20,815	—	21,988	2,025,548	159,176	2,184,724
Cash and cash equivalents in governmental banks	—	49,662	—	—	29,119	—	75,476	—	154,257	552,067	706,324
Investments	2,635,014	—	—	—	—	—	—	—	2,635,014	1,452,599	4,087,613
Receivables, net:											
Insurance premium	—	—	—	—	—	—	—	—	—	130,538	130,538
Intergovernmental	—	—	—	2,873	—	23,800	—	—	26,673	7,810	34,483
Accounts	—	5,569	726,481	80,751	—	14,525	3,003	—	830,329	137,905	968,234
Loans and advances	3,892,664	—	—	—	—	—	—	—	3,892,664	72,543	3,965,207
Accrued interest	259,624	—	2,773	—	958	—	24	—	263,379	38,701	302,080
Other governmental entities	—	—	162,109	89,588	20,594	3,271	—	1,846	277,408	84,444	361,852
Other	—	—	167,733	—	37,356	74,697	—	9,871	289,657	50,713	340,370
Due from:											
Primary government	—	—	195,780	—	—	7,570	—	65,930	269,280	79,553	348,833
Component units	692,202	—	17,970	—	—	23,381	—	—	733,553	62,677	796,230
Inventories	—	—	404,580	22,098	—	5,404	—	—	432,082	34,365	466,447
Prepaid expenses	—	2,607	2,510	5,941	683	832	—	204	12,777	21,194	33,971
Total current assets	9,390,224	88,422	1,720,856	201,772	88,710	174,295	78,503	99,839	11,842,621	2,884,285	14,726,906
Noncurrent assets:											
Restricted assets:											
Cash and cash equivalents in commercial banks	108,836	2,142	293,540	180,195	92,724	15,962	—	—	693,399	124,999	818,398
Cash and cash equivalents in governmental banks	—	36,476	517,304	47,685	21,053	—	4,284	—	626,802	446,536	1,073,338
Investments and other restricted assets	1,808,055	762,265	377,532	—	1,914,619	331,406	113,799	—	5,307,676	1,868,317	7,175,993
Investments	—	—	—	—	—	—	—	—	—	1,756,967	1,756,967
Receivables:											
Loans, interest, and other	—	—	—	—	—	2,797	17,625	—	20,422	138,183	158,605
Other governmental entities	—	—	—	—	—	—	—	—	—	55,096	55,096
Other	—	—	—	—	—	—	—	—	—	3,106	3,106
Due from:											
Primary government	—	—	—	—	—	89,200	—	—	89,200	—	89,200
Component units	878,553	—	—	—	—	—	—	—	878,553	16,637	895,190
Property held for sale or future development	58,118	—	—	—	—	—	—	—	58,118	193,984	252,102
Capital assets, not being depreciated	10,971	2,826,890	2,603,843	1,446,884	1,417,949	177,475	—	—	8,484,012	1,436,178	9,920,190
Capital assets, depreciable, net	16,426	8,494,600	3,570,150	4,230,283	130	661,600	—	385	16,973,574	2,282,832	19,256,406
Deferred expenses and other assets	44,812	131,820	148,371	61,774	59,530	44,910	109,621	—	600,838	217,101	817,939
Total noncurrent assets	2,925,771	12,254,193	7,510,740	5,966,821	3,506,005	1,323,350	245,329	385	33,732,594	8,539,936	42,272,530
Total assets	\$ 12,315,995	12,342,615	9,231,596	6,168,593	3,594,715	1,497,645	323,832	100,224	45,575,215	11,424,221	56,999,436

**COMMONWEALTH OF PUERTO RICO**  
Combining Statement of Net Assets (Deficit)– Major Component Units  
June 30, 2008  
(In thousands)

Liabilities and Net Assets	Major component units								Major component unit totals	Total nonmajor component units	Total component units
	Government Development Bank for Puerto Rico	Puerto Rico Highways and Transportation Authority	Puerto Rico Electric Power Authority	Puerto Rico Aqueduct and Sewer Authority	Puerto Rico Infrastructure Financing Authority	University of Puerto Rico	Puerto Rico Sales Tax Financing Corporation	Puerto Rico Health Insurance Administration			
Liabilities:											
Current liabilities:											
Accounts payable and accrued liabilities	\$ 84,126	183,106	765,375	386,188	126,133	111,607	985	187,316	1,844,836	843,132	2,687,968
Deposits and escrow liabilities	7,015,334	—	164,475	5,866	—	—	—	—	7,185,675	577,329	7,763,004
Due to:											
Primary government	—	—	—	12,649	—	—	—	7,239	19,888	115,604	135,492
Component units	—	83,571	113,065	100,724	798	25,072	—	—	323,230	473,000	796,230
Other governmental entities	—	—	—	—	—	—	—	—	—	19,749	19,749
Securities lending transactions and reverse repurchase agreements	687,200	—	—	—	—	—	—	—	687,200	202,939	890,139
Interest payable	24,955	154,015	137,497	33,176	64,435	6,752	37,013	—	457,843	118,256	576,099
Deferred revenue	—	—	—	19,067	77	—	—	—	19,144	106,701	125,845
Notes payable, current portion	119,704	—	1,139,335	2,564	—	—	—	—	1,261,603	194,220	1,455,823
Commonwealth appropriation bonds, current portion	151	—	—	7,950	155	—	—	—	8,256	1,670	9,926
Bonds payable, current portion	63,447	83,940	337,151	2,621	34,350	23,000	—	—	544,509	108,073	652,582
Accrued compensated absences, current portion	2,437	16,707	89,507	15,151	—	28,196	—	464	152,462	104,968	257,430
Liability for automobile accident insurance and work men compensation claims	—	—	—	—	—	—	—	—	—	817,440	817,440
Current portion of other long-term liabilities	—	3,615	79,767	—	—	863	—	—	84,245	30,254	114,499
Total current liabilities	7,997,354	524,954	2,826,172	585,956	225,948	195,490	37,998	195,019	12,588,891	3,713,335	16,302,226
Noncurrent liabilities:											
Due to:											
Primary government	—	—	—	280,641	—	—	—	—	280,641	7,108	287,749
Component units	—	—	—	8,748	23,713	35,760	104,528	—	172,749	722,441	895,190
Securities lending transactions and reverse repurchase agreements	—	—	—	—	—	—	—	—	—	104,800	104,800
Interest payable	3,220	—	—	—	—	1,934	—	—	5,154	—	5,154
Deferred revenue	—	—	—	—	—	143	—	—	143	18,620	18,763
Notes payable	595,625	—	79,899	247,436	—	—	—	—	922,960	1,530,107	2,453,067
Commonwealth appropriation bonds	4,811	—	—	678,503	10,312	—	—	—	693,626	201,744	895,370
Bonds payable	1,353,810	7,044,699	5,825,836	1,878,808	3,098,313	695,786	5,340,598	—	25,237,850	2,097,598	27,335,448
Accrued compensated absences	2,451	14,354	123,515	53,600	268	132,586	—	310	327,084	22,217	349,301
Other long-term liabilities	—	31,940	189,492	64,028	300	73,323	—	—	359,083	159,062	518,145
Total noncurrent liabilities	1,959,917	7,090,993	6,218,742	3,211,764	3,132,906	939,532	5,445,126	310	27,999,290	4,863,697	32,862,987
Total liabilities	9,957,271	7,615,947	9,044,914	3,797,720	3,358,854	1,135,022	5,483,124	195,329	40,588,181	8,577,032	49,165,213
Net assets (deficit):											
Invested in capital assets, net of related debt	27,397	3,991,522	55,101	2,955,388	1,418,080	279,696	—	385	8,727,569	1,806,743	10,534,312
Restricted for:											
Trust – nonexpendable	—	—	—	—	1,479,005	65,446	—	—	1,544,451	—	1,544,451
Capital projects	—	47,591	307,666	—	325,473	1,949	—	—	682,679	67,884	750,563
Debt service	30,523	576,139	—	—	18,537	51,875	—	—	677,074	129,857	806,931
Affordable housing and related loan insurance programs	259,979	—	—	—	—	—	—	—	259,979	308,494	568,473
Student loans and other educational purposes	54,386	—	—	—	—	7,948	—	—	62,334	8,632	70,966
Other specified purposes	—	—	—	12,024	140,945	24,706	—	—	177,675	116,973	294,648
Unrestricted	1,986,439	111,416	(176,085)	(596,539)	(3,146,179)	(68,997)	(5,159,292)	(95,490)	(7,144,727)	408,606	(6,736,121)
Total net assets (deficit)	2,358,724	4,726,668	186,682	2,370,873	235,861	362,623	(5,159,292)	(95,105)	4,987,034	2,847,189	7,834,223
Total liabilities and net assets	\$ 12,315,995	12,342,615	9,231,596	6,168,593	3,594,715	1,497,645	323,832	100,224	45,575,215	11,424,221	56,999,436

See accompanying notes to basic financial statements.

COMMONWEALTH OF PUERTO RICO  
Combining Statement of Activities - Major Component Units  
Year ended June 30, 2008  
(In thousands)

	Expenses	Program revenues			Net revenues (expenses) and changes in net assets	Payments from primary government	Payments from (to) other component units	General revenue and transfers				Special item	Change in net assets	Net assets, (deficit) beginning of year (as restated)	Net assets, (deficit) end of year
		Charges for services	Operating grants and contributions	Capital grants and contributions				Grants and contributions not restricted to specific programs	Taxes	Interest and investment earnings	Other				
Major component units:															
Government Development Bank for Puerto Rico	\$ 682,067	636,538	—	115,588	70,059	11,689	—	—	—	—	5,736	—	87,484	2,271,240	2,358,724
Puerto Rico Highways and Transportation Authority	1,030,586	273,591	—	158,784	(598,211)	—	—	—	291,841	38,298	—	—	(268,072)	4,994,740	4,726,668
Puerto Rico Electric Power Authority	4,711,791	4,362,209	—	—	(349,582)	—	—	38,982	—	25,874	—	—	(284,726)	471,408	186,682
Puerto Rico Aqueduct and Sewer Authority	1,033,399	695,735	34,023	—	(303,641)	50,610	—	—	—	5,714	11,181	369,025	132,889	2,237,984	2,370,873
Puerto Rico Infrastructure Financing Authority	214,659	—	—	—	(214,659)	91,252	—	—	—	231,496	5,397	—	113,486	122,375	235,861
University of Puerto Rico	1,418,033	171,996	141,734	—	(1,104,303)	893,759	71,759	127,514	—	5,296	5,171	—	(804)	363,427	362,623
Puerto Rico Sales Tax Financing Corporation	227,555	—	—	—	(227,555)	—	—	—	206,271	7,496	(45)	(4,970,436)	(4,984,269)	(175,023)	(5,159,292)
Puerto Rico Health Insurance Administration	1,735,504	593,886	—	—	(1,141,618)	989,386	—	—	—	10,540	—	—	(141,692)	46,587	(95,105)
Nonmajor component units	<u>2,869,402</u>	<u>1,872,055</u>	<u>65,851</u>	<u>102,006</u>	<u>(829,490)</u>	<u>423,725</u>	<u>(71,759)</u>	<u>11,901</u>	<u>66,218</u>	<u>195,986</u>	<u>72,663</u>	<u>98,665</u>	<u>(32,091)</u>	<u>2,879,280</u>	<u>2,847,189</u>
	<u>\$ 13,922,996</u>	<u>8,606,010</u>	<u>241,608</u>	<u>376,378</u>	<u>(4,699,000)</u>	<u>2,460,421</u>	<u>—</u>	<u>178,397</u>	<u>564,330</u>	<u>520,700</u>	<u>100,103</u>	<u>(4,502,746)</u>	<u>(5,377,795)</u>	<u>13,212,018</u>	<u>7,834,223</u>

See accompanying notes to basic financial statements.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

#### (1) **Summary of Significant Accounting Policies**

The Commonwealth of Puerto Rico (the Commonwealth) was constituted on July 25, 1952, under the provisions of its Constitution as approved by the people of Puerto Rico and the U.S. Congress. The Commonwealth's Constitution provides for the separation of powers of the executive, legislative, and judicial branches of the government. The Commonwealth assumes responsibility for public safety, health, public housing and welfare, education, and economic development.

The accompanying basic financial statements of the Commonwealth have been prepared in conformity with U.S. generally accepted accounting principles (GAAP) as prescribed by the Governmental Accounting Standards Board (GASB).

The accompanying basic financial statements present the financial position of the Commonwealth and its various funds, the results of operations of the Commonwealth and its various funds and fund types, and the cash flows of the proprietary funds. The basic financial statements are presented as of June 30, 2008 and for the year then ended. The basic financial statements include the various departments, agencies, boards, commissions, public trusts and public corporations, and any other organizational units governed by the Puerto Rico Legislature and/or officers of the Commonwealth.

##### **(a) *The Financial Reporting Entity***

The accompanying basic financial statements include all departments, agencies, and governmental entities whose funds are under the custody and control of the Secretary of the Treasury of the Commonwealth and the Commonwealth's component units pursuant to Act No. 230 of July 23, 1974, as amended, known as Commonwealth of Puerto Rico Accounting Law. The Commonwealth has considered all potential component units for which it is financially accountable and other organizations for which the nature and significance of their relationship with the Commonwealth are such that exclusion would cause the Commonwealth's basic financial statements to be misleading or incomplete. The GASB has set forth criteria to be considered in determining financial accountability. These criteria include appointing a voting majority of an organization's governing body and (1) the ability of the Commonwealth to impose its will on that organization or (2) the potential for the organization to provide specific financial benefits to, or impose specific financial burdens on, the Commonwealth.

As required by U.S. GAAP, these basic financial statements present the Commonwealth and its component units.

##### **(b) *Component Units***

Component units are entities that are legally separate organizations for which the Commonwealth's elected officials are financially accountable or other organizations for which the nature and significance of their relationship with the Commonwealth are such that exclusion would cause the Commonwealth's basic financial statements to be misleading or incomplete. GAAP details two methods of presentation: blending the financial data of the component units' balances and transactions in a manner similar to the presentation of the Commonwealth's balances and transactions; or discrete presentation of the component units' financial data in columns separate from the Commonwealth's balances and transactions. The Commonwealth is financially accountable

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

because it appoints the members of the governing authorities of each of the component units and because it is able to impose its will on these organizations or because the organizations provide specific financial benefits or impose specific financial burdens on, the Commonwealth. The financial statements of the component units discussed below have been included in the financial reporting entity either as blended component units or as discretely presented component units in accordance with GASB Statement No. 14, *The Financial Reporting Entity*, as amended by GASB Statement No. 39, *Determining Whether Certain Organizations are Component Units*.

#### **Blended Component Units**

The following entities, while legally separate from the Commonwealth, meet the criteria to be reported as part of the primary government because they provide services entirely or almost entirely to the Commonwealth.

***Public Buildings Authority (PBA)*** – PBA is governed by a seven-member board comprising the Secretary of the Department of Transportation and the Public Works (DTPW), the Secretary of the Department of Education of the Commonwealth, the President of the Government Development Bank for Puerto Rico (GDB), and four members appointed by the Governor of Puerto Rico with the advice and consent of the Senate. It is a legally separate entity, whose activities are blended within the primary government because it exists to construct, purchase, or lease office, school, health, correctional, social welfare, and other facilities for lease to the Commonwealth's departments, component units, and instrumentalities. Bonds issued by PBA to finance such facilities are payable from lease collections, which are largely derived from Commonwealth appropriations and are further secured by the Commonwealth's guaranty.

***Puerto Rico Maritime Shipping Authority (PRMSA)*** – PRMSA is governed by the President of GDB. The operations of PRMSA consist of servicing the long-term liability to third parties that resulted from the sale of certain maritime operations formerly owned and operated by PRMSA. The Commonwealth is required to annually appropriate funds in its general operating budget to provide for the payment of principal and interest on such debt [see note 15 (d)].

***The Children's Trust (the Trust)*** – The Trust is governed by a seven-member board comprising the Governor, who designates the president of the board, the President of GDB, the Director of the Office of Management and Budget (OMB) of the Commonwealth, the Secretary of Justice of the Commonwealth, and three private citizens appointed by the Governor with the consent of the Senate. The Trust's sole operation consists of providing financial assistance principally to the Commonwealth's departments to carry out projects aimed at promoting the well-being of families, children and youth of Puerto Rico, especially in the areas of education, recreation, and health. The operation of the Trust is financed with the moneys being received by the Commonwealth from a global settlement agreement (GSA) dated November 23, 1998 between certain tobacco companies and certain states, territories, and other jurisdictions of the United States of America, including the Commonwealth. The GSA calls for annual payments through the year 2025, which will vary due to inflationary and volume adjustments. After 2025, the tobacco companies shall continue making contributions in perpetuity.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

The blended component units are composed of various funds. The PBA capital projects fund and the Trust special revenue fund are presented as major governmental funds. All other funds are reported in the other governmental funds column. Complete financial statements of the blended component units can be obtained directly by contacting their respective administrative offices at:

Public Buildings Authority  
P.O. Box 41029 - Minillas Station  
San Juan, PR 00940-1029

Puerto Rico Maritime  
Shipping Authority  
P.O. Box 42001  
San Juan, PR 00940-2001

The Children's Trust  
P.O. Box 42001  
San Juan, PR 00940-2001

#### Discretely Presented Component Units

The following component units, consistent with GASB No. 14, are discretely presented in the basic financial statements because of the nature of the services they provide, the Commonwealth's ability to impose its will, principally through the appointment of their governing authorities, and because the component units provide specific financial benefits to, or impose financial burdens on, the Commonwealth. These have been classified by management between major and nonmajor component units. A major discretely presented component unit is defined by management as a component unit that meets 10% or more of total assets, liabilities, net assets, revenue or expenses of all discretely presented component units. If a component unit is expected to meet the minimum criteria for inclusion as major component unit in a future year, the Commonwealth may elect to report as a major component unit.

#### Major Component Units

***Government Development Bank for Puerto Rico (GDB)*** – GDB is governed by a seven-member board appointed by the Governor. GDB acts as fiscal agent, depository of funds, disbursing agent, investor, and financial advisor for the Commonwealth, its public corporations, and municipalities in connection with the issuance of bonds and notes; and it also makes loans and advances funds predominantly to the Commonwealth's departments, component units, and municipalities. GDB's boards of directors' members are executives on a trustworthy position, named and supervised by the Governor.

***Puerto Rico Aqueduct and Sewer Authority (PRASA)*** – PRASA is governed by a nine-member board comprising five members appointed by the Governor and confirmed by the Senate of Puerto Rico; the Executive President of PREPA, the President of the Puerto Rico Planning Board, the Executive Director of Mayor Federation, and the Executive Director of Mayors Association. PRASA owns and operates the system of public water supply and sanitary sewer facilities. PRASA is authorized, among other things, to borrow money and issue revenue bonds for any of its corporate purposes. As discussed in note 16(a), the Commonwealth guarantees the principal and interest payments of certain outstanding bonds and of all future bonds issued to refinance those outstanding bonds at the date of refinancing. Act No. 45 of July 28, 1994 was later amended to include other



## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

loans under the State Revolving Fund Program (SRFP). The Commonwealth provides financial support to PRASA through legislative appropriations.

***Puerto Rico Electric Power Authority (PREPA)*** – PREPA is governed by a nine-member board comprising the Secretary of DTPW, six members appointed by the Governor with the consent of the Senate, and two members representing the consumers' interest elected in a referendum carried out by the Puerto Rico Consumer Affairs Department. Board members are appointed or elected for a period of four years. PREPA is responsible for conserving, developing, and utilizing the power resources in order to promote the general welfare of Puerto Rico and owns and operates the Commonwealth's electrical power generation, transmission, and distribution system. The Commonwealth provides financial support to PREPA through legislative appropriations.

***Puerto Rico Health Insurance Administration (PRHIA)*** – PRHIA is governed by a Board of Directors, which, by law, is composed of nine members (four compulsory members and five discretionary members). The compulsory members are the Secretary of Health of the Commonwealth, the Secretary of the Treasury of the Commonwealth, the Insurance Commissioner of Puerto Rico, and the Administrator of the Administration of Mental Health and Anti-Addiction Services. The five discretionary members are appointed by the Governor, with the consent of the Senate. PRHIA was created for implementing, administering, and negotiating a health insurance system through contracts with insurance underwriters to provide quality medical and hospital care to low-income individuals, employees of the Commonwealth, and policemen who voluntarily subscribe to the Puerto Rico health insurance medical plan. The boards of directors' president is elected by the Governor and all board of directors' members are executives on a trustworthy position. The Commonwealth provides financial support to PRHIA through legislative appropriations.

***Puerto Rico Highways and Transportation Authority (PRHTA)*** – PRHTA is governed by the Secretary of DTPW. PRHTA has broad powers to carry out its responsibilities in accordance with DTPW's overall transportation policies. These powers include, among other things, the complete control and supervision of any highway facilities constructed, owned, or operated by PRHTA, the ability to set tolls for the use of the highway facilities, and the power to issue bonds, notes, or other obligations. PRHTA plans and manages the construction of all major projects relating to the Commonwealth's toll highway system, undertakes major repairs, and maintains the toll ways. The Commonwealth has the ability to significantly influence the toll rates charged by PRHTA.

***Puerto Rico Infrastructure Financing Authority (PRIFA)*** – PRIFA is governed by the board of directors of GDB and the Secretary of the Treasury of the Commonwealth. Its responsibilities are to provide financial, administrative, consulting, technical, advisory, and other types of assistance to other component units and governmental instrumentalities of the Commonwealth, which are authorized to develop infrastructure facilities and to establish alternate means for financing them. PRIFA's boards of directors' members are executives on a trustworthy position, named and supervised by the Governor. The Commonwealth provides financial support to PRIFA through legislative appropriations.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

***Puerto Rico Sales Tax Financing Corporation (known as COFINA by its Spanish acronym)*** – COFINA was created by Act No. 291 of December 26, 2006 as an independent governmental instrumentality to own and hold the dedicated sales tax fund (known as FIA by its Spanish acronym), for the purpose of financing the repayments and refunding of the Commonwealth's extra-constitutional debt. The FIA Fund was created by Act No. 91 of May 13, 2006 to receive and account for the first 1% of the sales and use tax established as described in note 15(d). The members of the board of directors of COFINA are the same as the ones of GDB.

***University of Puerto Rico (UPR)*** – UPR is governed by a 13-member board of trustees comprising one full-time student, two permanent professors, and 10 community citizens of the private sector, of which at least one must be graduated from the institution. Community citizens are designated by the Governor with the advice and consent of the Senate. Members designated by the Governor are appointed for a period of four to eight years. The terms for the student and professors are one year. The Commonwealth provides financial support to UPR through legislative appropriations.

#### **Nonmajor Component Units**

***Agricultural Services and Development Administration (ASDA)*** – ASDA is governed by the Secretary of Agriculture of the Commonwealth. The purpose of ASDA is to provide a wide variety of services and incentives to the agricultural sector. The Commonwealth has the ability to impose its will on ASDA. The Commonwealth provides financial support to ASDA through legislative appropriations.

***Automobile Accidents Compensations Administration (AACA)*** – AACA is governed by a four-member board appointed by the Governor with the advice and consent of the Senate. AACA operates a system of compulsory insurance coverage for all registered motor vehicles and compensates citizens for injuries arising from motor vehicle accidents. The Commonwealth has the ability to significantly influence rates charged by AACA.

***Cardiovascular Center Corporation of Puerto Rico and the Caribbean (CCCPRC)*** – CCCPRC is governed by a seven-member board comprising the Secretary of Health of the Commonwealth, the Director of the Medical Sciences Campus of the UPR, the Executive Director of the Puerto Rico Medical Services Administration, and four additional members appointed by the Governor with the consent of the Senate, one of which should be from the Cardiology Society of Puerto Rico and another a member of a cardiology foundation properly registered in the Department of State of the Commonwealth. The purpose of the CCCPRC is to provide special treatment to patients suffering from cardiovascular diseases. The Commonwealth provides financial support to CCCPRC through legislative appropriations.

***Culebra Conservation and Development Authority (CCDA)*** – CCDA was created to formulate and administer the program and plan for the conservation, use, and development of natural resources of the municipality of Culebra. CCDA is administered through a board of directors composed of seven members, including the Mayor of Culebra and six additional members appointed by the Mayor of Culebra and confirmed by the municipal legislature. The administration and operations of the CCDA are conducted by an executive director elected by the board of directors. The Commonwealth provides financial support to CCDA through legislative appropriations.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

***Economic Development Bank for Puerto Rico (EDB)*** – EDB is governed by a nine-member board comprising the President of GDB, who is the Chairman, the Secretary of Agriculture of the Commonwealth, the Secretary of the Department of Economic Development and Commerce of the Commonwealth, the Executive Director of the Puerto Rico Industrial Development Company, the Executive Director of the Tourism Company of Puerto Rico, and four other members representing the private sector and appointed by the Governor with the consent of the Senate. Private sector members are appointed for a maximum period of three years. EDB is responsible for the promotion and development of the private sector economy of the Commonwealth. This purpose is to be met by granting direct loans, loan guarantees, loan participation, and/or direct investments to any person or business organization devoted to manufacturing, agriculture, trade, tourism, or other service enterprises with preference, but not limited, to economic activities that may have the effect of substituting imports. The Commonwealth has the ability to impose its will on EDB.

***Employment and Training Enterprises Corporation (ETEC)*** – ETEC is governed by a 13-member consulting board, which includes two private citizens appointed by the Governor with the consent of the Senate. The purpose of ETEC is to provide training for management, business development, and employment for inmates of the correctional institutions of the Commonwealth. The Commonwealth generally provides financial support to ETEC through legislative appropriations.

***Farm Insurance Corporation of Puerto Rico (FICPR)*** – FICPR is governed by a five-member board consisting of the Secretary of Agriculture of the Commonwealth, the Dean of the Agricultural Sciences Faculty of the UPR Mayaguez Campus, a representative of GDB, and two bona fide farmers appointed by the Governor with the consent of the Senate. The purpose of the FICPR is to provide insurance to farmers against losses in their farms caused by natural disasters. The Commonwealth has the ability to impose its will on FICPR.

***Fine Arts Center Corporation (FACC)*** – FACC is governed by a nine-member board comprising the President of the Musical Arts Corporation and eight members named by the Governor. FACC was created with the purpose of administering the Fine Arts Center. The Commonwealth provides financial support to FACC through legislative appropriations.

***Governing Board of the 9-1-1 Service (911 Service)*** – The 911 Service is governed by a five-member board comprising the Chief of Police, the Executive Director of the Medical Emergency Services, the Director of the State Emergency Management Agency, the Chief of the Puerto Rico Firefighters Corps, and one member appointed by consensus of the four exofficio members to represent the public interest. The 911 Service is responsible for providing an efficient service of fast response to emergency calls through the 911 number and transferring these to the appropriate response agencies using technological and human resources to safeguard lives and properties. The Commonwealth has access to 911 Service's resources.

***Institute of Puerto Rican Culture (IPRC)*** – The IPRC is governed by a 10-member board comprising the President of Musical Arts Corporation and nine members appointed by the Governor with the advice and consent of the Senate. The IPRC is responsible for implementing the public policy related to the development of Puerto Rican arts, humanities, and culture. The Commonwealth provides financial support to IPRC through legislative appropriations.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

***Institutional Trust of the National Guard of Puerto Rico (ITNGPR)*** – ITNGPR is governed by a seven-member board comprising the Adjutant General of the Puerto Rico National Guard, the President of GDB, the Secretary of Justice of the Commonwealth, three militaries from the Puerto Rico National Guard, and one representative from the community recommended by the Adjutant General of the Puerto Rico National Guard and one representative from the community appointed by the Governor. ITNGPR's purpose is to provide life insurance, retirement benefits, and economic assistance to the active members of the Puerto Rico National Guard and their families. The Commonwealth generally provides financial support to ITNGPR through legislative appropriations.

***Land Authority of Puerto Rico (LAPR)*** – LAPR is governed by a five-member board consisting of the Secretary of Agriculture of the Commonwealth and four members appointed by the Governor. LAPR was created to carry out the provisions of the Land Law of Puerto Rico. LAPR maintains debt that is paid with Commonwealth's appropriations and funds generated by LAPR operations.

***National Parks Company of Puerto Rico (NPCPR)*** – NPCPR is governed by a nine-member board comprising the Secretary of Recreation and Sports of the Commonwealth (the Secretary), who is the chairman, the Secretary of Education of the Commonwealth, the Executive Director of the Puerto Rico Tourism Company (PRTC), the Secretary of Natural and Environmental Resources of the Commonwealth, and five members appointed by the Governor with the recommendation from the Secretary and with known interest in the development and preservation of parks in the private sector. NPCPR is responsible for the operation of all national parks and the protection, conservation, maintenance and use of parks, beaches, forests, and natural and historical monuments for the optimum enjoyment of present and future generations. The Commonwealth provides financial support to NPCPR through legislative appropriations.

***Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives (PCSDIPRC)*** – PCSDIPRC is governed by a nine-member board consisting of the Administrator of the Cooperative Development Administration, the Commissioner of Financial Institutions of Puerto Rico (the Commissioner of Financial Institutions), the Secretary of the Treasury of the Commonwealth, the Inspector of Cooperatives, three citizens representing the cooperative movement, one representative of the Puerto Rico Cooperatives League, and one private citizen representing the public interest. PCSDIPRC has the responsibility of providing to all the cooperatives and the Federation of Cooperatives of Puerto Rico insurance coverage over the stocks and deposits, and for monitoring the financial condition of the insured cooperatives, and the uninsured cooperatives when requested by the Inspector of Cooperatives. The Commonwealth has the ability to impose its will on PCSDIPRC.

***Puerto Rico Conservatory of Music Corporation (PRCMC)*** – PRCMC is governed by a seven-member board appointed by the Governor, with the consent of the Senate. PRCMC is responsible for providing the Puerto Rican community, and especially its youths, with the required facilities to educate and perfect their musical skills, including secondary education programs for developing musical arts. It prepares the artistic element that nourishes the Puerto Rico Symphony Orchestra and other musical organizations, and coordinates the governmental efforts to interested industries, private enterprises, and particular citizens. The Commonwealth provides financial support to PRCMC through legislative appropriations.



## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

***Puerto Rico Convention Center District Authority (PRCCDA)*** – PRCCDA is governed by a board comprising of nine members, four of which shall be from the public sector and five from the private sector. The public sector members comprise the Secretary of Economic Development and Commerce of the Commonwealth, who is the Chairman, the Executive Director of the PRTC, the president of GDB, and one member from the public sector. The private sector members are individuals having experience in the areas of hospitality, tourism, real estate, or convention centers who are appointed by the Governor with the advice and consent of the Senate. PRCCDA was created to develop, own, finance, plan, design, construct, operate, manage, and promote the new Puerto Rico Convention Center and the Puerto Rico Convention District. The PRCCDA also has the ownership interest as well as other rights and obligations related to the development and operations of the Jose Miguel Agrelot Coliseum. The Commonwealth provides financial support to PRCCDA through legislative appropriations.

***Puerto Rico Council on Higher Education (PRCHE)*** – PRCHE is governed by a board comprising eight members appointed by the Governor with the consent of the Senate and the Secretary of Education of the Commonwealth as an ex-officio member. Its purpose is to develop higher education, to administer the licensing and certification of institutions of higher education, and to administer scholarship funds. The Commonwealth provides financial support to PRCHE through legislative appropriations.

***Puerto Rico Government Investment Trust Fund (PRGITF)*** – PRGITF is governed by the Secretary of the Treasury of the Commonwealth. GDB is its trustee, custodian, and administrator. PRGITF's main objective is to provide investment opportunities in a professionally managed money market portfolio by investing in high-quality securities with minimal credit risk. Qualified investors include the Commonwealth's central government, its public corporations, instrumentalities and agencies, and the municipalities of Puerto Rico. In conformity with GASB Statement No. 31, *Accounting and Financial Reporting for Certain Investments and for External Investments Pools*, the financial statements of the PRGITF are not included in the accompanying basic financial statements because the primary government and each component unit investor is already presenting as cash or investment their corresponding share of the assets of the PRGITF (see note 5).

***Puerto Rico Industrial Development Company (PRIDCO)*** – PRIDCO is governed by a seven-member board comprising the Secretary of Economic Development and Commerce of the Commonwealth, who is the Chairman, the Secretary of the Treasury of the Commonwealth, the President of GDB, the President of the Planning Board of Puerto Rico, and three members from the private sector appointed by the Governor with the advice and consent of the Senate. The private sector members are appointed for a period of four years. PRIDCO administers the Commonwealth-sponsored economic development program by providing facilities, general assistance, and special incentive grants to manufacturing companies operating in Puerto Rico. PRIDCO has issued interim notes and revenue bonds to finance manufacturing plants and other facilities. Rentals derived from the leasing of specified facilities of PRIDCO are pledged for the payment of PRIDCO's revenue bonds. PRIDCO maintains debt that is paid with Commonwealth's appropriations. The Commonwealth provides financial support to PRIDCO through legislative appropriations.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

***Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority (known as AFICA by its Spanish acronym)*** – AFICA is governed by a seven-member board consisting of the Executive Director of PRIDCO, the President of GDB, the Executive Director of PRIFA, the Executive Director of the PRTC, the President of the Environmental Quality Board, and two private citizens appointed by the Governor. AFICA is authorized to issue revenue bonds to finance industrial, tourist, environmental control, medical, and educational facilities in Puerto Rico and the United States of America for use by private companies, nonprofit entities, or governmental agencies. The bonds are payable solely from collections from such private companies, nonprofit entities, or governmental agencies, and do not constitute debt of the Commonwealth or any of its other component units. The Commonwealth has access to AFICA's resources.

***Puerto Rico Land Administration (PRLA)*** – PRLA is governed by an 11-member board comprising the Secretary of Economic Development and Commerce of the Commonwealth, who serves as president, the Secretary of the Treasury of the Commonwealth, the Secretary of Agriculture of the Commonwealth, the Secretary of DTPW of the Commonwealth, the Secretary of Housing of the Commonwealth, the President of the Planning Board of Puerto Rico, the Executive director of Puerto Rico Industrial Development Corporation and four other members appointed by the Governor with the consent of the Senate. PRLA acquires parcels of land on behalf of government instrumentalities through negotiation or expropriation for future development or for reserve. The Commonwealth provides financial support to the PRLA through legislative appropriations.

***Puerto Rico Maritime Transportation Authority (PRMTA)*** – PRMTA is governed by the Secretary of DTPW of the Commonwealth. The operations of PRMTA consist of administering and operating the maritime transportation services between San Juan, Fajardo, Vieques, and Culebra. The Commonwealth provides financial support to PRMTA through legislative appropriations.

***Puerto Rico Medical Services Administration (PRMeSA)*** – PRMeSA is governed by a nine-member board comprising the Secretary of Health of the Commonwealth, who is the Chairman, the Dean of the Medical Sciences Faculty of the UPR, the President of the Board of the Puerto Rican Cancer Society, the Mayor of the municipality of San Juan, the Administrator of the State Insurance Fund Corporation (SIFC), the Administrator of the Administration of Mental Health and Anti-Addiction Services, the President of the Medical Policy and Administration Committee, and two users appointed by the Secretary of Health of the Commonwealth. Its purpose is to plan, organize, operate, and administer the centralized health services, provided in support of the hospital and other functions, offered by the member institutions and users of the medical complex known as the Puerto Rico Medical Center. The Commonwealth provides financial support to PRMeSA through legislative appropriations.

***Puerto Rico Metropolitan Bus Authority (PRMBA)*** – PRMBA is governed by the Secretary of DTPW of the Commonwealth. PRMBA provides bus transportation to passengers within the San Juan Metropolitan Area. The Commonwealth provides financial support to PRMBA through legislative appropriations.



## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

***Puerto Rico Municipal Finance Agency (PRMFA)*** – PRMFA is governed by a five-member board comprising the President of GDB, who is the Chairman, the Commissioner of Municipal Affairs, and three additional members appointed by the Governor, one of whom shall be either the mayor or chief financial officer of a municipality. PRMFA was organized to create a capital market to assist the municipalities of Puerto Rico in financing their public improvement programs.

***Puerto Rico Ports Authority (PRPA)*** – PRPA is governed by a five-member board consisting of the Secretary of DTPW of the Commonwealth, who is the Chairman, the Secretary of Economic Development and Commerce of the Commonwealth, the Executive Director of PRIDCO, the Executive Director of the PRTC, and one private citizen appointed by the Governor with the consent of the Senate. The purpose of PRPA is to administer all ports and aviation transportation facilities of the Commonwealth and to render other related services. The Commonwealth generally provides financial support to PRPA through legislative appropriations.

***Puerto Rico Public Broadcasting Corporation (PRPBC)*** – PRPBC is governed by an 11-member board of directors comprising the Secretary of Education of the Commonwealth, the President of the UPR, the Executive Director of IPRC, and eight private citizens appointed by the Governor with the advice and consent of the Senate. At least three of these private citizens must have proven interest, knowledge, and experience in education, culture, art, science, or radio and television. PRPBC was created for the purpose of integrating, developing, and operating the radio, television, and electronic communication facilities that belong to the Commonwealth. The Commonwealth provides financial support to PRPBC through legislative appropriations.

***Puerto Rico School of Plastic Arts (PRSPA)*** – PRSPA is governed by a seven-member board. Four members are appointed by the board of directors of IPRC, representing the public educational and cultural interests. Board members may not be employees of the PRSPA. The remaining three members are elected from among the members of the board of directors of IPRC, one of whom will serve as president. PRSPA was created to develop, promote, plan, and coordinate programs of study in higher education oriented to the plastic arts, teaching, artistic techniques, and to help students to develop humanistic values. The Commonwealth generally provides financial support to PRSPA through legislative appropriations.

***Puerto Rico Solid Waste Authority (PRSWA)*** – PRSWA is governed by a government board appointed by the Secretary of the Department of Natural Resources, whereby, the Secretary and the Executive Director of PRSMA periodically meet. PRSWA provides alternatives for processing of solid waste and encourages recycling, reuse, and recovery of resources from waste. The Commonwealth provides financial support to PRSWA through legislative appropriations.

***Puerto Rico Telephone Authority (PRTA)*** – PRTA is governed by a five-member board comprising the President of GDB and four members that are appointed by the board of directors of GDB. PRTA is the legal entity responsible to account for the equity interest in Telecommunications de Puerto Rico, Inc. for the benefit of the Employees' Retirement System of the Government of Puerto Rico and its instrumentalities (ERS). The Commonwealth generally provides financial support to PRTA through legislative appropriations.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

***Puerto Rico Tourism Company (PRTC)*** – PRTC is governed by a seven-member board comprising representatives of different tourist-related sectors appointed by the Governor with the consent of the Senate. At least one member must represent internal tourism and two must not be residents of the metropolitan area. Its purpose is to promote the tourism industry of Puerto Rico. The Commonwealth generally provides financial support to PRTC through legislative appropriations.

***Puerto Rico Trade and Export Company (PRTEC)*** – PRTEC is governed by an eight-member board comprising the Secretary of Department of Economic Development and Commerce, who is the Chairman, the Executive Director of the Ports Authority, the Secretary of the Department of Agriculture, the President of EDB, the Executive Director of PRIDCO, the Legal Division Director of PRTEC, and two private citizens. PRTEC has the responsibility to promote the highest efficiency in the services provided to the commercial sector, with emphasis on small- and medium-sized enterprises while promoting the export of products and services from Puerto Rico to other countries. The Commonwealth provides financial support to PRTEC through legislative appropriations.

***Right to Employment Administration (REA)*** – REA is governed by an administrator appointed by the Governor with the consent of the Senate. The Commonwealth provides financial support to REA through legislative appropriations and federal funds.

***Special Communities Perpetual Trust (SCPT)*** – SCPT is governed by a board of directors composed of 11 members: the Secretary of Housing of the Commonwealth, the Secretary of the DTPW of the Commonwealth, the Coordinator for the Social and Economic Financing of the Special Communities, one mayor of a municipality of Puerto Rico, one community leader resident in one special community, four private citizens representing the public interest, and two public employees. All members of the board of directors are appointed by the Governor. SCPT's principal purpose is to fund development projects that address the infrastructure and housing needs of the underprivileged communities. The Commonwealth provides financial support to SCPT through legislative appropriations.

***State Insurance Fund Corporation (SIFC)*** – SIFC is governed by a seven-member board appointed by the Governor with the advice and consent of the Senate. The board comprises the Commissioner of Insurance of Puerto Rico, an officer from the Department of Labor and Human Resources of the Commonwealth, an officer from the Department of Health of the Commonwealth (DOH), a representative of the employer's interest, a representative of the employees' interest, and two members without any of these interests. One of these members is appointed by the Governor as president of the board for a period of six years. The three public officials are appointed for a period of five years, and the rest of the members for four, three, two, and one year, respectively. SIFC provides workers' compensation and disability insurance to public and private employees. The Commonwealth has access to SIFC's resources.

Financial statements for the discretely presented component units can be obtained as follows:

Government Development Bank for Puerto Rico  
P.O. Box 42001  
San Juan, PR 00940 – 2001

Puerto Rico Aqueduct and Sewer Authority  
P.O. Box 7066  
San Juan, PR 00916-7066

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

Puerto Rico Electric Power Authority  
P.O. Box 364267  
San Juan, PR 00936-4267

Puerto Rico Health Insurance Administration  
P.O. Box 195661  
San Juan PR 00919-5661

Puerto Rico Highways and Transportation  
Authority  
P.O. Box 42007  
San Juan, PR 00940-2007

Puerto Rico Infrastructure Financing Authority  
Capital Center  
235 Arterial Hostos Ave., Suite 1600  
San Juan, PR 00918-1433

Puerto Rico Sales Tax Financing Corporation  
P.O. Box 42001  
San Juan PR 00940-2001

University of Puerto Rico  
Jardin Botanico Sur 1187  
Calle Flamboyán  
San Juan, PR 00926-1117

Agricultural Services and Development  
Administration  
P.O. Box 9200  
San Juan, PR 00908-0202

Automobile Accidents Compensations  
Administration  
P.O. Box 364847  
San Juan, PR 00936-4847

Cardiovascular Center Corporation of  
Puerto Rico and the Caribbean  
P.O. Box 366528  
San Juan, PR 00936-6528

Culebra Conservation and Development  
Authority  
P.O. Box 217  
Culebra, PR 00775-0217

Economic Development Bank for Puerto Rico  
P.O. Box 2134  
San Juan, PR 00922-2134

Employment and Training Enterprises  
Corporation  
P.O. Box 366505  
San Juan, PR 00936-6505

Farm Insurance Corporation of Puerto Rico  
P.O. Box 9200  
Santurce, PR 00908

Fine Arts Center Corporation  
P.O. Box 41287 – Minillas Station  
San Juan, PR 00940-1287

Governing Board of the 9-1-1 Service  
P.O. Box 270200  
San Juan, PR 00927-0200

Institute of Puerto Rican Culture  
P.O. Box 9024184  
San Juan, PR 00902-4184

Institutional Trust of the National Guard of  
Puerto Rico  
P.O. Box 9023786  
San Juan, PR 00902-3786

Land Authority of Puerto Rico  
P.O. Box 9745  
San Juan, PR 00908-9745

National Parks Company of Puerto Rico  
P.O. Box 902098  
San Juan, PR 00902-2089

Public Corporation for the Supervision and  
Deposit Insurance of Puerto Rico Cooperatives  
P.O. Box 195449  
San Juan, PR 00919-5449

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

Puerto Rico Conservatory of Music Corporation 951 Ave. Ponce de León San Juan, PR 00907-3373	Puerto Rico Convention Center District Authority P.O. Box 19269 San Juan, PR 00910-1269
Puerto Rico Council on Higher Education P.O. Box 19900 San Juan, PR 00910-1900	Puerto Rico Government Investment Trust Fund P.O. Box 42001 – Minillas Station San Juan, PR 00940-2001
Puerto Rico Industrial Development Company P.O. Box 362350 San Juan, PR 00936-2350	Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental Control Facilities Financing Authority P.O. Box 42001 San Juan, PR 00940-2001
Puerto Rico Land Administration P.O. Box 363767 San Juan, PR 00936-3767	Puerto Rico Maritime Transportation Authority, P.O. Box 362829 San Juan, PR 00940-2829
Puerto Rico Medical Services Administration P.O. Box 2129 San Juan, PR 00922-2129	Puerto Rico Metropolitan Bus Authority P.O. Box 195349 San Juan, PR 00919-5349
Puerto Rico Municipal Finance Agency P.O. Box 42001 San Juan, PR 00940-2001	Puerto Rico Ports Authority P.O. Box 362829 San Juan, PR 00936-2829
Puerto Rico Public Broadcasting Corporation P.O. Box 190909 San Juan, PR 00919-0909	Puerto Rico School of Plastic Arts P.O. Box 9021112 San Juan, PR 00902-1112
Puerto Rico Solid Waste Authority P.O. Box 40285 – Minillas Station San Juan, PR 00940-0285	Puerto Rico Telephone Authority P.O. Box 42001 San Juan, PR 00940-2001
Puerto Rico Tourism Company P.O. Box 9023960 Old San Juan Station San Juan, PR 00902-3960	Puerto Rico Trade and Export Company P.O. Box 195009 San Juan, PR 00919-5009

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

Right to Employment Administration  
P.O. Box 364452  
San Juan, PR 00936-4452

Special Communities  
Perpetual Trust  
P.O. Box 42001  
San Juan, PR 00940-2001

State Insurance Fund  
Corporation  
P.O. Box 365028  
San Juan, PR 00936-5028

The financial statements of the discretely presented component units have a year-end of June 30, 2008, except for the Puerto Rico Telephone Authority, which has a year-end of December 31, 2007.

#### **Fiduciary Component Units**

The three employee retirement systems administer pension funds for the Commonwealth and its political subdivisions. The three systems are subject to legislative and executive controls, and the administrative expenses are subject to legislative budget controls. These component units, while meeting the definition of a component unit and are legally separate, are presented in the fund financial statements along with other fiduciary funds of the Commonwealth. They have been omitted from the government-wide financial statements, as their resources are not available to fund the operations of the Commonwealth.

#### ***Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities (ERS)***

– ERS is governed by a board of trustees, which is composed of the Secretary of the Treasury of the Commonwealth, who is the President, the President of GDB, the Commissioner for Municipal Affairs, the Director of the Puerto Rico Central Office of Personnel Administration, two participating employees, and one retiree, who are appointed by the Governor. The Commonwealth reports ERS as a single-employer pension plan. ERS is the administrator of a defined-benefit pension plan, which covers all regular employees of the Commonwealth and its instrumentalities and of certain municipalities and component units not covered by their own retirement systems. On September 24, 1999, an amendment to the law that created ERS was enacted with the purpose of establishing a new defined-contribution plan (System 2000) for employees hired by the government on or after January 1, 2000.

***Puerto Rico Judiciary Retirement System (JRS)*** – JRS is governed by the same board of trustees as ERS. JRS is a single-employer defined-benefit plan, administered by ERS, which covers all individuals holding a position as Justice of the Supreme Court, Judge of the Superior Court or the District Court, or Municipal Judges of the Commonwealth.

***Puerto Rico System of Annuities and Pensions for Teachers (TRS)*** – TRS is governed by a nine-member board comprising the Secretary of Education of the Commonwealth, the Secretary of the Treasury of the Commonwealth, the President of GDB, two active teachers (one of them is a representative of the teachers' organization according to Act No. 45 of February 1998), two retired teachers, one representative of the teachers' organization, and one representative of the public



## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

interest appointed by the Governor with the advice and consent of the Senate for four years. The Commonwealth reports TRS as a single-employer pension plan. TRS provides retirement benefits to all teachers of the Department of Education of the Commonwealth, all pensioned teachers, all teachers transferred to an administrative position in the Department of Education of the Commonwealth, teachers who work in the Teachers' Association of Puerto Rico, and those who practice in private institutions accredited by the Department of Education of the Commonwealth. TRS provides retirement, death, and disability benefits.

Complete financial statements of these component units can be obtained directly by contacting their respective administrative offices at:

Employees' Retirement System of the  
Government of Puerto Rico and its  
Instrumentalities  
P.O. Box 42003 – Minillas Station  
Santurce, PR 00940

Puerto Rico Judiciary  
Retirement System  
P.O. Box 42003 – Minillas Station  
Santurce, PR 00940

Puerto Rico System of Annuities and Pensions  
for Teachers  
P.O. Box 191879  
San Juan, PR 00919-1879

#### (c) *Government-Wide Financial Statements*

The government-wide financial statements (the statement of net assets and the statement of activities) report information of all of the nonfiduciary activities of the Commonwealth and its component units. For the most part, the effect of interfund activity has been removed from these government-wide financial statements. Governmental activities, which normally are supported by taxes and intergovernmental revenue, are reported separately from business-type activities, which rely to a significant extent on fees and charges for support. Likewise, the primary government is reported separately from the legally separate component units for which the primary government is financially accountable. The statement of net assets presents the reporting entities' nonfiduciary assets and liabilities, with the difference reported as net assets. Net assets are reported in three categories:

- ***Invested in Capital Assets, Net of Related Debt*** – These consist of capital assets, net of accumulated depreciation and amortization and reduced by outstanding balances for bonds, notes, and other debt that are attributed to the acquisition, construction, or improvement of those assets.
- ***Restricted Net Assets*** – These result when constraints are placed on net assets' use either externally imposed by creditors, grantors, contributors, and the like or imposed by law through constitutional provisions or enabling legislation.
- ***Unrestricted Net Assets*** – These consist of net assets that do not meet the definition of the two preceding categories. Unrestricted net assets often are designated to indicate that management



## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

does not consider them to be available for general operations. Unrestricted net assets often have constraints on resources that are imposed by management, but can be removed or modified.

When both restricted and unrestricted resources are available for use, generally, it is the Commonwealth's policy to use restricted resources first, then the unrestricted resources as they are needed.

The statement of activities demonstrates the degree to which the direct expenses of a given function, segment, or component unit are offset by program revenue. Direct expenses are those that are clearly identifiable with a specific function, segment, or component unit. Program revenue includes charges to customers who purchase, use, or directly benefit from goods or services provided by a given function, segment, or component unit. Program revenue also includes grants and contributions that are restricted to meeting the operational or capital requirements of a particular function, segment, or component unit. Taxes and other items not properly included among program revenue are reported instead as general revenue. Resources that are dedicated internally are reported as general revenue rather than as program revenue. The Commonwealth does not allocate general government (indirect) expenses to other functions.

**(d) *Measurement Focus, Basis of Accounting, and Financial Statement Presentation***

***Government-Wide Financial Statements*** – The government-wide financial statements are reported using the economic resources measurement focus and the accrual basis of accounting. Revenue is recorded when earned and expenses are recorded when a liability is incurred, regardless of the timing of related cash flows. Grants and similar items are recognized as revenue as soon as all eligibility requirements have been met.

***Governmental Fund Financial Statements*** – The governmental fund financial statements are reported using the current financial resources measurement focus and the modified-accrual basis of accounting. Revenue is recognized as soon as it is both measurable and available. Revenue is considered to be available when it is collectible within the current period or soon enough thereafter to pay liabilities of the current period. Principal revenue sources considered susceptible to accrual include tax revenue, net of estimated overpayments (refunds) and amounts considered not collectible, which are recorded as taxpayers earn income (income taxes), as sales are made (consumption, sales and use taxes) and as cash is received (miscellaneous taxes). For this purpose, the Commonwealth considers income tax revenue to be available if collected within 120 days after the end of the current fiscal year-end and consumption sales and is tax if collected within 30 days after the end of the current fiscal year. In applying the susceptible to accrual concept to federal grants, there are essentially two types of revenue. For the majority of grants, moneys must be expended by the Commonwealth on the specific purpose or project before any amounts will be reimbursed. Revenue is, therefore, recognized as expenditures are incurred to the extent available. For the other revenue, moneys are virtually unrestricted and are generally revocable only for failure to comply with prescribed compliance requirements. These resources are reflected as revenue at the time of receipt or earlier if the susceptible to accrual criteria is met. Expenditures are generally recorded when a liability is incurred, as under accrual accounting. Modifications to the accrual basis of accounting include the following:

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

- Employees' vested annual vacation and sick leave are recorded as expenditures when utilized. The amount of accumulated annual vacation and sick leave unpaid at June 30, 2008 has been reported only in the government-wide financial statements.
- Interest and principal on general long-term obligations are recorded when due, except for interest and principal due on July 1 of the following fiscal year, if resources are available for its payment as of June 30.
- Executory purchase orders and contracts are recorded as a reservation of fund balance.
- Debt service expenditures, federal funds' cost disallowances, other long-term obligations, and amounts subject to judgments under litigation are recorded only when payment is due.

***Proprietary Funds, Fiduciary Funds, and Discretely Presented Component Units Financial Statements*** – The financial statements of the proprietary funds, fiduciary funds, and discretely presented component units are reported using the economic measurement focus and the accrual basis of accounting, similar to the government-wide financial statements described above.

Each enterprise fund has the option under GASB Statement No. 20, *Accounting and Financial Reporting for Proprietary Funds and Other Governmental Entities That Use Proprietary Fund Accounting*, to elect and apply all Financial Accounting Standards Board (FASB) pronouncements issued after November 30, 1989, unless these conflict with a GASB pronouncement. The primary government's major enterprise funds have elected not to apply FASB pronouncements issued after November 30, 1989 and two nonmajor enterprise funds elected to adopt the FASB's pronouncements issued after November 30, 1989. Also, certain discretely presented component units have disclosed their election in their separately issued financial statements. The component units follow U.S. GAAP as issued by GASB and FASB as applicable to each component unit based on the nature of their operations. In addition, the Puerto Rico Government Investment Trust Fund adopted GASB Statement No. 31; however, such financial statements are not included in the accompanying basic financial statements because the primary government and each component unit's investor already present their corresponding share of the assets of the PRGITF as cash or investments.

Proprietary funds distinguish operating revenue and expenses from nonoperating items. Operating revenue and expenses generally result from providing services and producing and delivering goods in connection with a proprietary fund's principal ongoing operations. Revenue and expenses not meeting this definition are reported as nonoperating revenue and expenses. The major operating revenue of the Commonwealth enterprise funds is as follows:

- Unemployment Insurance Fund – Amounts requisitioned for the Puerto Rico Unemployment Insurance Trust Fund held by the U.S. Treasury for payment of unemployment benefits and charges made to individual employers.
- Lotteries Fund – Amounts collected from the sale of traditional lottery tickets and electronic lotto games.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

#### (e) *Fund Accounting*

The Commonwealth reports its financial position and results of operations in funds, which are considered separate accounting entities, and discrete presentations of those component units, which are not required to be blended. The operations of each fund are accounted for within a set of self-balancing accounts. Fund accounting segregates funds according to their intended purpose and is used to aid management in demonstrating compliance with legal, financial, and contractual provisions. Major funds are determined using a predefined percentage of the assets, liabilities, revenue, or expenditures/expenses of either the fund category or the governmental and enterprise funds combined. The nonmajor funds are combined in a single column in the fund financial statements. The Commonwealth reports the following major funds:

#### **Governmental Funds**

***General Fund*** – The general fund is the primary operating fund of the Commonwealth. It is used to account for all financial transactions, except those required to be accounted for in another fund. Included are transactions for services such as general government, public safety, health, public housing and welfare, and education.

***Debt Service Fund*** – The debt service fund accounts for the accumulation of resources predominantly for, and the payment of, general long-term bonds' principal, interest, and related costs other than bonds payable from the operations of proprietary fund types, pension trust funds, and discretely presented component units. Long-term debt and interest due on July 1 of the following fiscal year are accounted for as a fund liability if resources are available as of June 30 for its payment.

***Capital Project Fund*** – Capital project funds are used to account for the financial resources used by the primary government for the acquisition or construction of major capital facilities not being financed by the Public Buildings Authority's Capital Projects Fund, proprietary fund types, pension trust funds, and discretely presented component units.

***Public Buildings Authority's Capital Projects Fund*** – The Public Buildings Authority's capital projects fund is used to account for the financial resources used for the acquisition or construction of major capital facilities not financed by proprietary fund types, pension trust funds, and discretely presented component units.

***The Children's Trust Special Revenue Fund*** – The Children's Trust special revenue fund is used to account for the moneys received by the Commonwealth from a global settlement agreement dated November 23, 1998 between certain tobacco companies and certain states, territories, and other jurisdictions of the United States of America, including the Commonwealth. The financial resources received by this fund are used to carry out projects aimed at promoting the well-being of children and youth of Puerto Rico.

#### **Proprietary Funds**

These funds account for those activities for which the intent of management is to recover, primarily through user charges, the cost of providing goods or services to the general public.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

***Unemployment Insurance Fund*** – This fund accounts for amounts requisitioned for the Puerto Rico Unemployment Insurance Trust Fund held by the U.S. Treasury for payment of unemployment benefits and charges made to individual employers.

***Lotteries Fund*** – This fund accounts for the assets and operations of two lottery systems administered by the Commonwealth.

#### **Fiduciary Funds**

Fiduciary funds are used to account for assets held by the Commonwealth in a trustee capacity, or as an agent for individuals, private organizations, and other governmental units. The following are the Commonwealth's fiduciary funds:

***Pension Trust Funds*** – These are used to account for the assets, liabilities, and net assets available for pension benefits held in trust for the public employees' retirement systems.

***Agency Funds*** – These are custodial in nature (assets equal liabilities) and do not involve measurement of the results of operations.

#### **Discretely Presented Component Units**

Discrete presentation of component units is used to present the financial information of entities that do not qualify to be blended, in accordance with GASB No. 14 as amended by GASB No. 39, with the funds of the primary government. The component units column in the government-wide financial statements is used to report the financial activities of the Commonwealth's discretely presented component units. The financial statements of these component units are presented following the accrual basis of accounting. Under the accrual basis, revenue is recognized when earned and expenses are recorded as liabilities when incurred, without regard to receipt or payment of cash.

#### **(f) Statutory (Budgetary) Accounting**

The Commonwealth's budget is adopted in accordance with a statutory basis of accounting, which is not in accordance with GAAP. Revenue is generally recognized when cash is received, net of tax refunds claimed by taxpayers as of year-end. Short-term and long-term borrowings may be used to finance budgetary excess of expenditures over revenue. Expenditures are generally recorded when the related expenditure is incurred or encumbered. Encumbrances generally lapse the year following the end of the fiscal year when the encumbrance was established, as established by Act No. 123 of August 17, 2001. Unencumbered appropriations lapse at year-end. Amounts required for settling claims and judgments against the Commonwealth and certain other liabilities are not recognized until they are encumbered or otherwise processed for payment.

Under the statutory basis of accounting, the Commonwealth uses encumbrance accounting to record the full amount of purchase orders, contracts, and other commitments of appropriated resources as deductions from the appropriation prior to actual expenditure. In the governmental funds, encumbrance accounting is a significant aspect of budgetary control.

The statement of revenue and expenditures – budget and actual – budget basis – general fund only presents the information for the general fund for which there is a legally adopted budget, as required



## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

by GAAP. See note 3(b) for a reconciliation of the statement of revenue and expenditures – budget and actual – budget basis – general fund with the statement of revenue, expenditures, and changes in fund deficit for the general fund. The special revenue funds do not have a legally mandated budget.

**(g) *Cash and Short-Term Investments***

The Commonwealth follows the practice of pooling cash. The balance in the pooled cash accounts is available to meet current operating requirements, and any excess is invested in various interest-bearing accounts with GDB and with the PRGITF. Cash and cash equivalents include investments with original maturities of 90 days or less from the date of acquisition.

The Commissioner of Financial Institutions requires that private financial institutions deposit collateral securities to secure the deposits of the Commonwealth and all other governmental entities in each of these institutions. The amount of collateral securities to be pledged for the security of public deposits shall be established by the rules and regulations promulgate by the Commissioner of Financial Institutions.

The Puerto Rico Unemployment Insurance Trust Fund is maintained to account for the collection of unemployment insurance contributions from employers and the payment of unemployment benefits to eligible claimants. As required by federal law, all resources not necessary for current benefit payments are placed on deposit with the U.S. Treasury. Interest earned over such deposit is retained in the fund.

Cash and short-term investments and cash equivalents of the component units are maintained in separate bank accounts, from those of the primary government, in their own names.

**(h) *Securities Purchased under Agreements to Resell***

Certain component units of the Commonwealth enter into purchases of securities with simultaneous agreements to resell. The securities underlying these agreements mainly consist of U.S. government obligations, mortgage-backed securities, and interest-bearing deposits with other banks.

**(i) *Securities Lending Transactions***

Certain component units of the Commonwealth enter into securities lending transactions in which governmental entities (lenders) transfer their securities to broker-dealers and other entities (borrowers) for collateral with a simultaneous agreement to return the collateral for the same securities in the future. Securities received as collateral are generally reflected as investments with a corresponding liability resulting from the obligation to return such collateral.

**(j) *Investments***

Investments include U.S. government and agencies' obligations, mortgage-backed securities, repurchase agreements, commercial paper, local government obligations, investment contracts, and corporate debt and equity obligations. Investment securities, including investments in limited partnerships, are presented at fair value, except for money market investments and participating investment contracts with a remaining maturity at the time of purchase of one year or less and nonparticipating investment contracts, which are presented at cost. Changes in the fair value of

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

investments are presented as investment earnings in the statement of activities, the statement of revenue, expenditures, and changes in balance – governmental funds, and the statement of revenue, expenses, and changes in fund net assets – proprietary funds. Fair value is determined based on quoted market prices. When securities are not listed on national exchanges, quotations are obtained from brokerage firms.

The PRGITF is considered a 2a7-like external investment pool and, as such, reports its investments at amortized cost.

The reverse repurchase agreements reported by certain discretely presented component units are authorized transactions under their respective enabling legislation and authorized by GDB.

#### **(k) Receivables**

Tax receivables in the general fund include predominantly amounts owed by taxpayers for individual and corporate income taxes, net of estimated uncollectible amounts. Income tax receivables are recognized as revenue when they become measurable and available based on actual collections during the 120 days following the fiscal year-end related to tax returns due before year-end. Taxes receivables also include amounts owed by taxpayers on income earned in periods prior to June 30, 2008, estimated to be collectible but not currently available, and thus are reported as deferred revenue in the general fund. Unemployment, disability, and driver's insurance receivables in the enterprise funds are stated net of estimated allowances for uncollectible accounts. During fiscal year 2007, the Commonwealth started imposing a general sales and use tax. The sales and use tax receivable is recognized as revenue when it becomes measurable and available based on actual collections during the 30 days following the fiscal year-end related to sales and use tax returns due before year-end.

Accounts receivable are stated net of estimated allowances for uncollectible accounts, which are determined, based upon past collection experience and current economic conditions. Intergovernmental receivables primarily represent amounts owed to the Commonwealth for reimbursement of expenditures incurred pursuant to federally funded programs. Intergovernmental receivables also include taxes that the Municipal Revenue Collection Center (CRIM, as per its Spanish acronym), a municipal corporation, is required to remit to the Commonwealth to be used by the Commonwealth's debt service fund for payment of debt service on general obligations of the Commonwealth. The amount to be remitted is based on the special tax of 1.03% of the assessed value of all real and personal property not exonerated from taxation, which is levied by the CRIM.

The accounts receivable from nongovernmental customers of the component units are net of estimated uncollectible amounts. These receivables arise primarily from service charges to users. Accounts receivable from the primary government and other component units that arise from service charges do not have allowances for uncollectible accounts, as these are deemed fully collectible.

Loans of the general fund represent predominantly amounts owed by public corporations and municipalities for public insurance and rent paid by the general fund on their behalf.

The loans of the pension trust funds do not have allowances for uncollectible amounts since such loans are secured by mortgage deeds, plan members' contributions, and any unrestricted amounts



## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

remaining in escrow. Loans of the component units consist predominantly of loans to the primary government, other component units, and municipalities, and do not have allowances for uncollectible accounts as those are deemed fully collectible. The remaining loans of the component units are to small and medium businesses, agricultural, and low-income housing loans from nongovernmental customers, and are presented net of estimated losses on such portfolios.

**(l) Inventories**

Generally, inventories are valued at cost and predominantly on the first-in, first-out basis. Governmental fund inventories are recorded as expenditures when purchased rather than capitalized as an asset. Only significant amounts of inventory at the end of the year are capitalized in the governmental funds. However, inventories are always capitalized in the statement of net assets of governmental activities.

**(m) Restricted Assets**

Funds set aside for the payment and guarantee of notes and interest payable and for other specified purposes are classified as restricted assets since their use is limited for this purpose by applicable agreements or required by law. Restricted assets in the proprietary funds mainly include amounts set aside for the payment of insurance benefits.

**(n) Real Estate Held for Sale**

Real estate held for sale are carried at the lower of fair value or cost, which is established by a third-party professional assessment or based upon an appraisal, minus estimated costs to sell. Subsequent declines in the value of real estate available for sale are charged to expenditure/expense.

**(o) Capital Assets**

Capital assets, which include land, buildings, building improvements, equipment, vehicles, construction in process, and infrastructure assets, are reported in the applicable governmental, business-type activities, and component unit columns in the government-wide financial statements. The Commonwealth's primary government defines capital assets as assets that have an initial, individual cost of \$25,000 or more at the date of acquisition and have a useful life of five or more years. Capital assets are recorded at historical cost or at estimated historical cost if actual historical cost is not available.

The method to deflate the current cost of the same or a similar asset using an approximate price index was used to estimate the historical cost of certain land, buildings, and building improvements, because invoices and similar documentation were no longer available in certain instances. Donated capital assets are recorded at fair market value at the time of donation. Major outlays for capital assets and improvements are capitalized as projects are constructed. Interest costs are capitalized during the construction period only for business-type activities and most component units. The costs of normal maintenance and repairs that do not add value to the assets or materially extend asset lives are not capitalized.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

Capital assets utilized in the governmental funds are recorded as expenditures in the governmental fund financial statements. Depreciation expense is recorded in the government-wide financial statements, as well as the proprietary funds and component units' financial statements.

Capital assets of the primary government are depreciated on the straight-line method over the assets' estimated useful life. There is no depreciation recorded for land and construction in progress. The estimated useful life of capital assets is as follows:

	<u>Years</u>
Buildings and building improvements	20 – 50
Equipment, furniture, fixtures, and vehicles	5 – 5
Infrastructure	50

The capital assets of the component units are recorded in accordance with the applicable standards of the component units and under their own individual capitalization thresholds. Depreciation has been recorded when required by these standards based on the types of assets, use and estimated useful lives of the respective assets, and on the nature of each of the component unit's operations.

The estimated useful lives of capital assets reported by the component units are as follows:

	<u>Years</u>
Buildings and building improvements	3 – 50
Equipment, furniture, fixtures, and vehicles	3 – 20
Infrastructure	10 – 50

The Commonwealth follows the provisions of GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries—an amendment to GASB Statement No. 34*. This statement establishes guidance for accounting and reporting for the impairment of capital assets and for insurance recoveries.

**(p) Tax Refunds Payable**

During the calendar year, the Commonwealth collects individual income taxes through withholdings and payments from taxpayers. At June 30, the Commonwealth estimates the amount owed to taxpayers for overpayments during the first half of the calendar year. These estimated amounts and the actual tax refunds claimed for prior years but not paid at year-end are recorded as tax refunds payable and as a reduction of tax revenue.

**(q) Deferred Revenue**

Deferred revenue at the governmental fund level arises when potential revenue does not meet either the “measurable” or the “available” criteria for revenue recognition in the current period. Deferred revenue also arises when resources are received before the Commonwealth has a legal claim to them,

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

as when grant moneys are received prior to incurring the qualifying expenditures. In subsequent periods, when the revenue recognition criteria is met, or when the Commonwealth has a legal claim to the resources, the liability for deferred revenue is removed from the balance sheet, and the revenue is recognized. Deferred revenue at the government-wide and proprietary fund levels arises only when the Commonwealth receives resources before it has a legal claim to them.

**(r) Long-Term Debt**

The liabilities reported in the government-wide financial statements include the Commonwealth's general obligation bonds and long-term notes, obligations under lease/purchase agreements, and long-term liabilities including vacation, sick leave, long-term liabilities to other governmental entities, net pension obligation, legal claims, and noncurrent federal fund cost disallowances related to expenditures of federal grants. Long-term obligations financed by proprietary fund types and component units are recorded as liabilities in those funds and in the discretely presented component units column.

Premiums, discounts, and issuance costs – in the government-wide financial statements, long-term debt, and other long-term obligations – are presented in the columns for governmental and business-type activities. The same is presented in the proprietary fund financial statements. Bond and note premiums and discounts, as well as issuance costs, are deferred and amortized over the life of the debt. Bonds and notes payable are reported net of the applicable bond premium or discount. Bond issuance costs are reported as deferred charges in other assets and are amortized over the term of the related debt. In the governmental fund financial statements, governmental funds recognize bond premiums and discounts, as well as bond issuance costs, during the current period. The face amount of debt issued is reported as other financing sources. Premiums received on debt issuance are reported as other financing sources while discounts are reported as other financing uses. Issuance costs, whether or not withheld from the actual debt proceeds received, are reported as expenditures.

The difference between reacquisition price and the net carrying amount of the old debt in a refunding transaction is deferred and amortized as a component of interest over the remaining life of the old debt, or the life of the new debt, whichever is shorter. On the statement of net assets, this deferred amount is reported as a deduction from, or as an addition to, the new debt liability.

**(s) Reservations of Fund Balance – Governmental Funds**

The governmental fund financial statements present fund balance reserves for those portions of fund balance (1) not available for appropriation for expenditures or (2) legally segregated for a specific future use. Reserves for encumbrances, debt service, and other specific purposes are examples of the latter.

**(t) Accounting for Pension Costs**

For the purpose of applying the requirements of GASB Statement No. 27, *Accounting for Pensions by State and Local Government Employers*, as amended by GASB No. 50, *Pension Disclosures*, the Commonwealth's financial reporting entity is considered to be a sponsor of three single-employer defined-benefit pension plans: ERS, JRS, and the TRS. This is because substantially all the participants in the three pension trust funds are part of the financial reporting entity of the

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

Commonwealth. For the purpose of the basic financial statements, and as disclosed in note 20, the Commonwealth's annual pension cost, measured on the accrual basis of accounting, for the year ended June 30, 2008 amounted to approximately \$1,525 million. However, the amount recognized as pension expenditure in the governmental funds was recorded under the modified accrual basis, and amounted to approximately \$774 million. The excess of the annual required contribution over the statutorily required contributions increased the net pension obligation at June 30, 2008 to approximately \$5.8 billion. This amount is presented in the statement of net assets (deficit) of the governmental activities as of June 30, 2008.

For purposes of the stand-alone financial statements of each of the blended and discretely presented component units, the entities accounted for pension costs from the standpoint of a participant in a multiple-employer cost sharing plan. Accordingly, pension costs recognized are equal to the statutorily or contractually required contributions, with a liability recorded for any unpaid required contributions. The basis of accounting used by the component units was either modified accrual basis or accrual basis, depending upon individual fund structure and type of entity. Most component units did not have pension-related assets or liabilities at transition because they have contributed the statutorily required contributions.

**(u) Other postemployment benefits**

In addition to the pension benefits described in note 20, the Commonwealth provides other postemployment benefits (OPEB) such as summer and Christmas bonus, and postemployment healthcare benefits for its retired employees in accordance with local law. Substantially, all of the employees may become eligible for these benefits if they reach normal retirement age while working for the Commonwealth.

The Christmas bonus and the summer bonus benefits are provided by the Commonwealth statutes. The Christmas bonus paid to the retired employees during the year ended June 30, 2008 was \$400 per retiree and the total amount was approximately \$53 million. These benefits are recorded as expenditures when paid in the general fund. The summer bonus paid to the retired employees during the year ended June 30, 2008 was \$100 per retiree and the total amount was approximately \$13 million. These benefits are recorded as an expense in the pension trust fund.

During the year ended June 30, 2008, the Commonwealth implemented GASB Statement No. 45, *Accounting and Financial Reporting by Employers for Postemployment Benefits Other than Pension*, the objective of which is to establish standards for the measurement, recognition, and display of other postemployment benefits (OPEB), expenditures and related assets and liabilities, note disclosures, and if applicable, required supplementary information (RSI) in the financial reports of state local governmental employers.

Healthcare benefits are provided through insurance companies whose premiums are paid by the retiree with the Commonwealth providing a matching share of not more than \$100 per month for each retiree. During the year ended June 30, 2008, the cost of providing healthcare benefits amounted to approximately \$106 million for 108,516 retirees. Beginning on July 1, 2007, the contribution for postemployment healthcare benefits is accrued as incurred in the accompanying statement of net assets in accordance with GASB Statement No. 45. Prior to July 1, 2007, the contribution for postemployment healthcare benefits was expensed when paid.



## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

(v) ***Compensated Absences***

The vacation policy of the Commonwealth generally provides for the accumulation of 2.5 days per month, except for the teachers who accrue 4 days per month. Vacation time accumulated is fully vested to the employees from the first day of work up to a maximum of 60 days. Employees accumulate sick leave generally at a rate of 1.5 days per month up to a maximum of 90 days. Upon retirement, an employee receives compensation for all accumulated unpaid leave at the current rate, if the employee has at least 10 years of service with the Commonwealth. Accrued compensated absences of the primary government at June 30, 2008 amounting to approximately \$1.8 billion are presented in the statement of net assets (deficit). Compensated absence accumulation policies for the blended component units and discretely presented component units vary from entity to entity based on negotiated agreements and other factors agreed upon between the management of these entities and their employees.

The Public Service Personnel Law requires certain component units and the primary government of the Commonwealth to annually pay the employees the accumulated vacation and sick leave earned in excess of the limits mentioned above.

(w) ***Interfund and Intraentity Transactions***

The Commonwealth has the following types of transactions among funds:

***Interfund Transfer*** – Legally required transfers that are reported when incurred as transfer-in by the recipient fund and as transfer-out by the disbursing fund, with receivables and payables presented as amounts due to and due from other funds. Advances between funds are also presented as amounts due to and due from other funds. However, these transfers and related amounts receivable and payable are considered internal balances and activities that have been eliminated in the government-wide financial statements.

***Intraentity Transactions*** – There are two types of intraentity transactions. First, are resource flows between the primary government and its component units and among the component units. These resource flows and related outstanding balances are reported as if they were external transactions. However, resource flows between the primary government and blended component units are classified as interfund transactions, as described above. Second, are intraentity balances between the primary government funds and discretely presented component units that are tantamount to long-term debt financing. The primary government's liability is reported in the statement of net assets, the proceeds in the primary government's funds, and the asset in the discretely presented component units' statement of net assets.

(x) ***Lottery Revenue and Prizes***

The revenue, expenses, and prizes awarded by the Lottery of Puerto Rico and the Additional Lottery System, reported within the lotteries enterprise fund, are recognized as drawings are held. Moneys collected prior to June 30 for tickets related to drawings to be conducted subsequent to June 30 are reported as deferred revenue. Unpaid prizes awarded as of June 30 are reported as a fund liability. Unclaimed prizes expire after six months and are transferred to the general fund.



## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

**(y) Risk Management**

The Commonwealth purchases commercial insurance covering casualty, theft, tort claims, and other losses for the primary government, most component units, and the municipalities. The Commonwealth is reimbursed for premium payments made on behalf of the component units and the municipalities. The current insurance policies have not been canceled or terminated. For workers' compensation, the Commonwealth has a discretely presented component unit, the SIFC, which provides workers' compensation to both public and private employees. In the past three years, the Commonwealth has not settled claims that exceed insurance coverage.

Certain component units combine commercial insurance with internal self-insurance funds covering specific risks related to their specialized operations.

**(z) Tobacco Settlement**

The Commonwealth follows GASB Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues* (the TB), which provides accounting guidance for entities created to obtain the rights to all or a portion of future tobacco settlement resources and for the governments that create such entities.

The TB indicates that the entity created to obtain the rights, which is called the Tobacco Settlement Authority (TSA), should be considered a component unit of the government that created it and the component unit should be blended. The TB also states that the government receiving the payments from the tobacco companies under the agreement, which are called settling governments, should recognize a receivable and revenue for tobacco settlement resources (TSRs) when an event occurs. The event that results in the recognition of an asset and revenue by the settling government is the domestic shipment of cigarettes. The TB indicates that accruals should be made by the settling government and TSAs for estimated shipments from January 1 to their respective fiscal year-ends, since the annual payments are based on a calendar year. However, under the modified accrual basis of accounting at the fund level, revenue should be recognized only to the extent that resources are available.

**(aa) Reclassifications**

Certain reclassifications have been made to the information presented in the separately issued financial statements of certain blended component units and agencies included within the special revenue, debt service, capital projects, proprietary funds, and discretely presented component units to conform to the accounting classifications used by the Commonwealth in the basic financial statements.

**(bb) Use of Estimates**

The preparation of the basic financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the basic financial statements and the reported amounts of revenue and expenses during the reporting period. Actual results could differ from those estimates.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

#### **(cc) Future Adoption of Accounting Pronouncements**

The GASB has issued the following accounting standards that have effective dates after June 30, 2008:

- GASB Statement No. 49, *Accounting and Financial Reporting for Pollution Remediation Obligations*. This statement addresses accounting and financial reporting standards for pollution (including contamination) remediation obligations, which are obligations to address the current or potential detrimental effects of existing pollution by participating in pollution remediation activities such as site assessments and cleanups. This statement is effective for periods beginning after December 15, 2007.
- GASB Statement No. 51, *Accounting and Financial Reporting for Intangible Assets*. This statement requires that all intangible assets not specifically excluded by its scope provisions be classified as capital assets. This statement is effective for periods beginning after June 15, 2009.
- GASB Statement No. 52, *Land and Other Real Estates Held as Investments by Endowments*. This statement requires endowments to report their land and other real estate investments at fair value. Governments also are required to report the changes in fair value as investment income and to disclose the method and significant assumptions employed to determine fair value, and other information that they currently present for other investments reported as fair value. This statement is effective for periods beginning after June 15, 2008.
- GASB Statement No. 53, *Accounting and Financial Reporting for Derivative Instruments*. This statement addresses the recognition, measurement, and disclosure of information regarding derivative instruments entered into by state and local governments. Derivative instruments are often complex financial arrangements used by governments to manage specific risks or to make investments. This statement is effective for periods beginning after June 15, 2009.
- GASB Statement No. 54, *Fund Balance Reporting and Governmental Fund Type Definitions*. This Statement establishes fund balance classifications that comprise a hierarchy based primarily on the extent to which a government is bound to observe constraints imposed upon the use of the resources reported in governmental funds. This statement is effective for periods beginning after June 15, 2010.

The impact of these statements on the Commonwealth's basic financial statements has not yet been determined.

#### **(2) Component Units**

The Commonwealth follows the provisions of GASB Statement No. 14, as amended by GASB Statement No. 39. The basic financial statements of the Commonwealth include the financial statements of the following component units that were audited by other auditors:

Blended component units:

Public Buildings Authority

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

Puerto Rico Maritime Shipping Authority  
The Children's Trust

Discretely presented component units:

Agricultural Services and Development Administration  
Automobile Accidents Compensations Administration  
Cardiovascular Center Corporation of Puerto Rico and the Caribbean  
Culebra Conservation and Development Authority  
Economic Development Bank for Puerto Rico  
Employment and Training Enterprises Corporation  
Farm Insurance Corporation of Puerto Rico  
Fine Arts Center Corporation  
Governing Board of the 9-1-1 Service  
Government Development Bank for Puerto Rico  
Institute of Puerto Rican Culture  
Institutional Trust of the National Guard of Puerto Rico  
Land Authority of Puerto Rico  
National Parks Company of Puerto Rico  
Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives  
Puerto Rico Conservatory of Music Corporation  
Puerto Rico Convention Center District Authority  
Puerto Rico Council on Higher Education  
Puerto Rico Electric Power Authority  
Puerto Rico Government Investment Trust Fund  
Puerto Rico Health Insurance Administration  
Puerto Rico Highways and Transportation Authority  
Puerto Rico Industrial Development Company  
Puerto Rico Industrial, Tourist, Educational, Medical, and Environmental  
Control Facilities Financing Authority  
Puerto Rico Infrastructure Financing Authority  
Puerto Rico Land Administration  
Puerto Rico Maritime Transportation Authority  
Puerto Rico Medical Services Administration  
Puerto Rico Metropolitan Bus Authority  
Puerto Rico Municipal Finance Agency  
Puerto Rico Ports Authority  
Puerto Rico Public Broadcasting Corporation  
Puerto Rico Sales Tax Financing Corporation  
Puerto Rico School of Plastic Arts  
Puerto Rico Solid Waste Authority  
Puerto Rico Telephone Authority  
Puerto Rico Tourism Company  
Puerto Rico Trade and Export Company  
Right to Employment Administration

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

Special Communities Perpetual Trust  
State Insurance Fund Corporation  
University of Puerto Rico

Fiduciary component units:

Employees' Retirement System of the Government  
of Puerto Rico and its Instrumentalities  
Puerto Rico Judiciary Retirement System  
Puerto Rico System of Annuities and Pensions for Teachers

### (3) Stewardship, Compliance, and Accountability

#### (a) *Budgetary Control*

The Governor is constitutionally required to submit to the Legislature an annual balanced budget of the Commonwealth for the ensuing fiscal year. The annual budget is prepared by the Commonwealth's OMB and takes into consideration the advice provided by the Puerto Rico Planning Board (annual economic growth forecasts and four-year capital improvements plan), the Department of the Treasury of the Commonwealth (revenue estimates, accounting records, and the comprehensive annual financial report), GDB (fiscal agent), and other governmental offices and agencies. Section 7 of Article VI of the Constitution of Puerto Rico provides that "The appropriations made for any fiscal year shall not exceed the total revenue, including available surplus, estimated for the said fiscal year, unless the imposition of taxes sufficient to cover the said appropriations is provided by law."

The annual budget, which is developed utilizing elements of program budgeting, includes an estimate of revenue and other resources for the ensuing fiscal year under: (1) laws existing at the time the budget is submitted; and (2) legislative measures proposed by the Governor and submitted with the proposed budget, as well as the Governor's recommendations as to appropriations that in his judgment are necessary, convenient, and in conformity with the four-year capital improvements plan adopted by the Puerto Rico Planning Board.

The Legislature may amend the budget submitted by the Governor but may not increase any items so as to cause a deficit without imposing taxes or identifying other sources of revenue to cover such deficit. Upon passage by the Legislature, the budget is referred to the Governor who may decrease or eliminate any line item but may not increase or insert any new line item in the budget. The Governor may also veto the budget in its entirety and return it to the Legislature with his objections. The Legislature, by two-thirds majority in each house, may override the Governor's veto. If a budget is not adopted prior to the end of the fiscal year, the annual budget for the preceding fiscal year, as approved by the Legislature and the Governor, is automatically renewed for the ensuing fiscal year until a new budget is approved by the Legislature and the Governor. This permits the Commonwealth to continue making payments for its operating and other expenses until the new budget is approved. The appropriated annual budget for fiscal year 2008 amounted to approximately \$5.6 billion. The Legislature also made several special budgetary appropriations to the general fund throughout the year, which amounted to approximately \$3.6 billion.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

The OMB has authority to amend the budget within a department, agency, or government unit without legislative approval.

For budgetary purposes, encumbrance accounting is used. The encumbrances (that is, purchase orders, and contracts) are considered expenditures when a commitment is made. For GAAP reporting purposes, encumbrances outstanding at year-end are reported as reservations of budgetary appropriations within GAAP fund balances and do not constitute expenditures or liabilities on a GAAP basis because the commitments will be honored during the subsequent year. The unencumbered balance of any appropriation of the general fund at the end of the fiscal year lapses immediately. Appropriations, other than in the general fund, are continuing accounts for which the Legislature has authorized that an unspent balance from the prior year be carried forward and made available for current spending.

During any fiscal year in which the resources available to the Commonwealth are insufficient to cover the appropriations approved for such year, the Governor may take administrative measures to reduce expenses and submit to both houses of the Legislature a detailed report of any adjustment necessary to balance the budget, or make recommendations to the Legislature for new taxes or authorize borrowings under provisions of existing legislation or take any other necessary action to meet the estimated deficiency. Any such proposed adjustments shall give effect to the “priority norms” established by law for the disbursement of public funds in the following order of priority; first, the payment of the interest on and amortization requirements for public debt (Commonwealth general obligations and guaranteed debt for which the Commonwealth’s guarantee has been exercised); second, the fulfillment of obligations arising out of legally binding contracts, court decisions on eminent domain, and other unavoidable obligations to protect the name, credit, and good faith of the Commonwealth; third, current expenditures in the areas of health, protection of persons and property, education, welfare, and retirement systems; and fourth, all other purposes.

In addition, the Legislature may direct that certain revenue be retained and made available for spending within a specific appropriation account. Generally, expenditures may not exceed the level of spending authorized for an individual department. However, the Commonwealth is statutorily required to pay debt service, regardless of whether such amounts are appropriated. Appropriations are enacted for certain departments, agencies, and government units included in the general fund. For these funds, a statement of revenue and expenditures – budget and actual budget basis – general fund is included. Appropriations for capital projects are made for each bond issue and the authorization continues for the expected construction period.

The OMB has the responsibility to ensure that budgetary spending control is maintained on an individual department basis. OMB may transfer part or all of any unencumbered balance within a department to another department subject to legislative approval. Budgetary control is exercised through the Puerto Rico Integrated Financial Accounting System (PRIFAS). PRIFAS ensures that encumbrances or expenditures are not processed if they exceed the department’s total available spending authorization, which is considered its budget. The legal level of budgetary control is at the individual department level for general fund expenditures, principal, and interest due for the year for the debt service fund, and by bond authorization for capital expenditures.



## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

**(b) Budget/GAAP Reconciliation**

The following schedule presents comparisons of the legally adopted budget with actual data on a budget basis. Because accounting principles applied for purposes of developing data on a budget basis differ significantly from those used to present financial statements in conformity with GAAP, a reconciliation of entity, timing, and basis differences in the excess (deficiency) of revenue and other financing sources over expenditures and other financing uses for the year ended June 30, 2008 is presented below for the general fund (expressed in thousands):

Excess of expenditures and other financing uses over revenue and other financing sources – budget basis	\$ (674,407)
Entity differences:	
Excess (deficiency) of revenue and other financing sources over expenditures and other financing uses for:	
Nonbudgeted funds	(687,654)
Inclusion of agencies with independent treasuries	(66,408)
Timing differences:	
Current year expenditure against prior year encumbrances	(55,011)
Basis of accounting differences:	
Net decrease in taxes receivable (net of tax refunds)	(4,734)
Net increase in other receivables	396,813
Net increase in deferred revenue	(171,737)
Excess of expenditures and other financing uses over revenue and other financing sources – GAAP basis	\$ <u>(1,263,138)</u>

The Commonwealth's amended budgeted expenditures (including transfers) for fiscal year 2008 of \$9.2 billion exceeded projected revenues (including transfers) of \$8.8 billion by approximately \$406 million. The Commonwealth expected to cover this budget deficit through the implementation of additional expenditure reducing measures, a possible increase in tax revenues resulting from the reduction of the uncertainty surrounding the government's fiscal crisis, and cash management mechanisms. The possible increase in tax revenues was tempered by the adverse economic impact resulting from increases in the price of oil and the implementation of the sales and use tax.

**(c) Deficit Net Assets**

The following activities, funds, and discretely presented component units reflect deficit fund balance/net assets at June 30, 2008 (expressed in thousands):

Primary government:	
Governmental activities	\$ 17,815,330
General fund	1,770,885
Enterprise fund – Lotteries	153,144

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

Component units:

Puerto Rico Sales Tax Financing Corporation	\$ 5,159,292
Agricultural Services and Development Administration	110,358
Special Communities Perpetual Trust	104,242
Puerto Rico Health Insurance Administration	95,105
Land Authority of Puerto Rico	87,113
Puerto Rico Medical Services Administration	58,492
Cardiovascular Center Corporation of Puerto Rico and the Caribbean	32,436
Employment and Training Enterprises Corporation	6,779
Puerto Rico Maritime Transportation Authority	3,192
Right to Employment Administration	960

The Commonwealth's governmental activities show a deficit of approximately \$17.8 billion, mostly attributed to long-term obligations amounting to approximately \$26 billion, which are recognized in the statement of net assets (deficit). The deficit is attributable to the accumulated effect of high operating expenses in the government along with a decrease in estimated revenues as well as the primary government issuing debt, the proceeds of which are to certain extent transferred to component units and to other governments, and which are not presented in these basic financial statements. On the other hand, the discretely presented component units report net assets of approximately \$7.8 billion. This inverse relationship between the governmental activities and component units' net assets reveal the operational structure of the Commonwealth where the primary government issues debt, the proceeds of which are transferred to the component units and to other governments as well, that are not presented in these basic financial statements, to finance their capital projects and other operational needs. The Commonwealth includes within the annual budgetary appropriation process the necessary funds to cover the annual debt service requirements of the aforementioned debt, most of which are the result of Act No. 164 of December 17, 2001, described in note 15(d).

The new administration has developed and commenced implementing a multiyear Fiscal Stabilization and Economic Reconstruction Plan that seeks to achieve fiscal balance and restore economic growth and acknowledges that fiscal stabilization is central to safeguarding the Commonwealth's investment-grade credit rating and restoring Puerto Rico's economic growth and development. During the first quarter of 2009, the Legislative Assembly enacted three bills providing for the implementation of this plan, which is composed of two main elements: the Fiscal Stabilization Plan (the Fiscal Plan) and the Economic Reconstruction Plan (the Economic Plan). For additional information on the Economic Plan see note 22.

The Additional Lottery System activities show a deficit of approximately \$153 million, mostly attributed to a payment amounting to \$200 million made in 2004 to the Commonwealth. This transaction was authorized pursuant to Act No. 171, dated July 29, 2004, which among other things authorized the Secretary of the Treasury of the Commonwealth to provide funding for the payment of lotto prize annuities upon depletion of other resources available at the Additional Lottery System. It is the opinion of the additional lottery management that the deficiency is not an indication of financial difficulties for the payment of long-term lotto prizes because funds will be provided from either the Additional Lottery System or from financial assistance provided by the Commonwealth.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

The \$5.1 billion deficit of the Puerto Rico Sales Tax Financing Corporation (COFINA) results from the nature and purpose for which the entity was created. This deficit will be financed with future sales tax revenue pledged for the payment of COFINA's debt.

#### (4) Changes in Reporting Entity and Restatement

The following table illustrates the change to fund deficit and net deficit at the beginning of the year as previously reported in the statement of revenue, expenditures and changes in fund deficit – general fund and in the governmental activities' statement of net assets, respectively. The changes resulted from the effect of a net understatement in capital assets amounting to \$3.4 million. The beginning balances have been restated as follows (expressed in thousands):

	<u>Fund deficit</u>	<u>Net deficit – governmental activities</u>
Beginning balance, as previously reported	\$ (511,158)	(18,438,894)
Unrecorded capital outlays/capital assets	3,411	3,411
Beginning balance, as restated	<u>\$ (507,747)</u>	<u>(18,435,483)</u>

The following table summarizes changes to net assets at the beginning of the year as previously reported in the statement of net assets by certain discretely presented component units. The changes resulted primarily from exclusions of nonmajor component units in the current year's presentation, and restatements to correct errors in the prior year's financial statements of certain component units (expressed in thousands):

Beginning net assets, as previously reported	\$ 13,156,109
Restatements of major component units audited by other auditors	(9,687)
Restatements of nonmajor component units audited by other auditors	70,149
Nonmajor component unit audited by other auditors included in fiscal year 2008, but excluded in fiscal year 2007	(6,341)
Nonmajor component unit audited by other auditors included in fiscal year 2007 but excluded in fiscal year 2008 (Musical Arts Corporation)	1,788
	<u>\$ 13,212,018</u>

All of the above restatements arise from activities and component units that were audited by other auditors (note 2).

#### (5) Puerto Rico Government Investment Trust Fund (PRGITF)

PRGITF was created by Act No. 176, of August 11, 1995, and began operations on December 4, 1995. PRGITF is a no-load diversified collective investment trust administered by GDB that was created for the purpose of providing eligible governmental investors of Puerto Rico with a convenient and economical way to invest in a professionally managed money market portfolio. PRGITF is not an investment company or a mutual fund and is not subject to regulation or registration under the investment company Act of 1940. Units issued by PRGITF are not subject to regulation or registration under the Securities and Exchange Act

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

of 1933, as amended, because the units are issued by a government entity. The deposits on hand and the investments purchased are not collateralized, secured, or guaranteed by the Commonwealth or any of its agencies, instrumentalities, or political subdivisions.

PRGITF is considered a 2a7-like external investment pool, and as such, reports its investment at amortized cost.

The investment securities on hand at June 30, 2008 consisted of certificates of deposit, bank notes, corporate obligations, commercial paper, and U.S. government and agencies obligations, all of which may be considered highly liquid. However, the participants' investments are subject to the ability of PRGITF to receive payment from the securities' issuer when due. The liquidity of certain investments and changes in interest rates may affect PRGITF's yield and the fair value of its investments.

The dollar amount of the deposits on hand at June 30, 2008 at \$1.00 per unit of participation was reported in the individual financial statements of each of the participants, and combined in the basic financial statements as follows (expressed in thousands):

	<u>Balance outstanding</u>	<u>Percentage of total</u>
Primary government:		
Commonwealth	\$ 415,235	71.38%
The Children's Trust	44,792	7.70
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	<u>2</u>	<u>—</u>
Total for primary government	<u>460,029</u>	<u>79.07%</u>
Discretely presented component units:		
Government Development Bank for Puerto Rico	45,555	7.83
Puerto Rico Aqueduct and Sewer Authority	34,357	5.91
State Insurance Fund Corporation	30,524	5.25
Institutional Trust of the National Guard of Puerto Rico	3,839	0.66
Puerto Rico Infrastructure Financing Authority	3,757	0.65
Puerto Rico Highways and Transportation Authority	289	0.05
Puerto Rico Land Administration	668	0.11
Puerto Rico Solid Waste Authority	612	0.11
Public Corporation for the Supervision and Deposit Insurance of Puerto Rico Cooperatives	524	0.09
Puerto Rico Electric Power Authority	<u>742</u>	<u>0.13</u>
Total for component units	<u>120,867</u>	<u>20.79%</u>
Other governmental entities	<u>792</u>	<u>0.14</u>
Total for all participants	<u>\$ 581,688</u>	<u>100.00%</u>

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

The deposits at June 30, 2008 were invested in securities with a cost that approximates fair value, plus accrued interest, for approximately \$581.7 million. The external portion of PRGITF was not considered significant for separate reporting in the accompanying basic financial statements.

Following is a table of the investments and other assets held at June 30, 2008 presented at amortized cost (expressed in thousands):

Commercial paper	\$	213,358
U.S. government and agencies' obligations		201,085
Securities purchased under agreements to resell		62,542
Corporate obligations		28,767
Certificates of deposits		60,000
Time deposits		15,000
Other assets		936
Total	\$	<u>581,688</u>

### (6) Deposits and Investments

Pursuant to the provisions of Act No. 91 of March 29, 2004, the primary government may invest in different types of securities, including domestic, international, and fixed income securities, among others.

The primary government maintains a cash and investment pool that is available for use by all funds, except for the fiduciary funds. Each fund's portion of this pool is reported on the statement of net assets as cash and cash equivalents. The fiduciary funds investments are held and managed separately from those of other primary government funds.

#### *Primary Government*

Cash and cash equivalents consist of demand deposits, interest-bearing accounts, certificates of deposit, bank investment contracts, and deposits invested in PRGITF (note 5).

The carrying amount of deposits of the primary government at June 30, 2008 consists of the following (expressed in thousands):

	Carrying amount			Bank balance
	Unrestricted	Restricted	Total	
Commercial banks and U.S. Treasury	\$ 282,751	620,170	902,921	1,813,922
Component unit banks	939,456	1,128,094	2,067,550	2,805,996
Total	<u>\$ 1,222,207</u>	<u>1,748,264</u>	<u>2,970,471</u>	<u>4,619,918</u>

Custodial credit risk is the risk that in the event of bank failure, the primary government's deposit might not be recovered. The Commonwealth requires that public funds deposited in commercial banks in Puerto Rico must be fully collateralized for the amount deposited in excess of federal depository insurance. All



## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

securities pledged as collateral are held by banks in the Commonwealth's name. There is no formal policy for custodial credit risk for cash accounts opened with commercial banks outside of Puerto Rico.

At year-end, the Commonwealth's bank balance of deposits in commercial banks amounting to \$146 million was covered by federal depository insurance or by collateral held by the Commonwealth's agent in the Commonwealth's name. Deposits of approximately \$547 million with the U.S. Treasury represent unemployment insurance taxes collected from employers that are transferred to the federal Unemployment Insurance Trust Fund in the U.S. Treasury. These deposits are uninsured and uncollateralized. The bank balance of deposits in component unit banks, which as of June 30, 2008 amounted to approximately \$2.1 billion, are also uninsured and uncollateralized. These deposits in component unit's banks are maintained with GDB and EDB. Deposits maintained in GDB and EDB are exempt from the collateral requirement established by the Commonwealth and thus represent a custodial credit risk, because in the event of GDB's or EDB's failure, the Commonwealth may not be able to recover these deposits.

Deposits in component unit banks represent the balance of interest and noninterest-bearing accounts in GDB and EDB. The deposit liability at GDB and EDB is substantially related to deposits from other component units and of the Commonwealth. The deposit liability does not agree with the governmental cash balances shown above because of reconciling items such as outstanding checks and deposits in transit.

The bank balance of GDB's and EDB's deposits at June 30, 2008 is broken down as follows (expressed in thousands):

Primary government	\$ 4,619,918
Discretely presented components units	<u>1,050,813</u>
Total pertaining to the Commonwealth	5,670,731
Municipalities of Puerto Rico	542,248
Other nongovernmental entities	637,255
Certificates of indebtedness	11,800
Escrow accounts	<u>530,753</u>
Total deposits per GDB and EDB	<u>\$ 7,392,787</u>

Unrestricted deposits include approximately \$582 million that are invested in PRGITF (note 5). Such amount has been included as cash and cash equivalents in the primary government's statement of net assets (deficit).

### **Investments**

#### ***Custodial Credit Risk***

Custodial credit risk for investments is the risk that, in the event of the failure of the counterparty to the transaction, the primary government may not be able to recover the value of the investment or collateral securities that are in the possession of an outside party. At June 30, 2008, securities investments were registered in the name of the Commonwealth and were held in the possession of the Commonwealth's custodian bank.

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

### Primary Government

The fair value by investment type, credit quality ratings, and maturity of the unrestricted investments reported by the governmental activities at June 30, 2008 consists of the following (expressed in thousands):

	Fair market value	Investment rating		Investment maturity less than one year
		AAA to A	Not rated	
Investment pool	\$ 30,183	30,183	—	30,183
Guaranteed investment contract	83,684	83,684	—	83,684
PRGTF	44,792	44,792	—	44,792
Other	66	66	—	66
Total investments	\$ 158,725	158,725	—	158,725

### Business-Type Activities

The fair value by investment type, credit quality ratings, and maturity of the restricted investments reported by the business-type activities at June 30, 2008 consists of the following (expressed in thousands):

	Fair value	Investment rating		
		AAA to A	BBB+	Not rated
Mortgage-backed securities	\$ 6,952	6,774	—	178
U.S. government and agency securities	8,765	8,765	—	—
U.S. equity securities	14,796	14,796	—	—
U.S. corporate debt securities	4,003	3,451	352	200
Other	121	65	—	56
Total	\$ 34,637	33,851	352	434

	Fair value	Maturity (in years)			
		Less than 1 year	1 to 5 years	6 to 10 years	More than 10 years
Mortgage-backed securities	\$ 6,952	41	4,761	865	1,285
U.S. government and agency securities	8,765	—	4,961	—	3,804
U.S. equity securities	14,796	14,796	—	—	—
U.S. corporate debt securities	4,003	177	2,363	1,463	—
Other	121	30	—	—	91
Total	\$ 34,637	15,044	12,085	2,328	5,180

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

#### ***Component Units***

Cash, and cash equivalents, of the component units at June 30, 2008 consist of (expressed in thousands):

	Carrying amount			Bank balance
	Unrestricted	Restricted	Total	
Commercial banks	\$ 2,184,724	818,398	3,003,122	3,032,458
Component unit banks	706,324	1,073,338	1,779,662	1,736,718
Total	<u>\$ 2,891,048</u>	<u>1,891,736</u>	<u>4,782,784</u>	<u>4,769,176</u>

Cash and cash equivalents consist of demand deposits, interest-bearing accounts, certificates of deposit, and bank investment contracts.

Custodial credit risk is the risk that, in the event of bank failure, the component unit's deposits might not be recovered. The Commonwealth requires that public funds deposited in commercial banks in Puerto Rico must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of the Commonwealth. There is no formal policy for custodial credit risk for cash accounts opened with commercial banks outside of Puerto Rico.

Deposits maintained in GDB and EDB are exempt from the collateral requirement established by the Commonwealth and thus represent a custodial credit risk because in the event of GDB's or EDB's failure, the Commonwealth may not be able to recover the deposits.

The component units were exposed to the following custodial credit risk arising from the balance of deposits maintained in commercial and component unit banks at June 30, 2008 (expressed in thousands):

Uninsured and uncollateralized	\$ 1,736,718
Uninsured and collateralized, with securities held by the pledging financial institutions	3,031,417
Uninsured and collateralized, with securities held by the pledging financial institutions but not in the component unit's name	<u>1,041</u>
Total	<u>\$ 4,769,176</u>

#### **Investments**

The component units' investment policies allow management to purchase or enter into the following investment instruments:

- U.S. government and agencies obligations
- Certificates and time deposits
- Bankers' acceptances
- Obligations of the Commonwealth of Puerto Rico and municipalities

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

- Federal funds sold
- Securities purchased under agreements to resell
- World Bank securities
- Corporate debt, including investment contracts
- External investment pools
- Stock of corporations created under the laws of the United States of America or the Commonwealth
- Options, futures, and interest-rates swap agreements for hedging and risk control purposes, as well as for the creation of synthetic products that qualify under any of the foregoing investment categories.
- Open-end mutual funds with acceptable underlying assets and rated AAA by Standard & Poor's or AAA by Moody's Investors Service
- A few component units, principally SIFC, are also allowed to enter into foreign currency investments, under certain limitations

The component units' investment policies establish limitations and other guidelines on amounts to be invested in the aforementioned investment categories and by issuer/counterparty and on exposure by country. In addition, such policies provide guidelines on the institutions with which investment transactions can be entered into.

The component units' investment policies provide that investments transactions shall be entered into only with counterparties that are rated BBB+/A-1 or better by the Standard & Poor's or equivalent rating by Fitch or Moody's Investors Service, depending on the type and maturity of the investment and the counterparty to the transaction. Also, the investment policy specifies that no more than 5% of a manager's assets at fair value shall be invested in the securities of any single issuer.

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

All investments in U.S. Treasury securities and mortgage-backed securities guaranteed by GNMA carry the explicit guarantee of the U.S. government and are presented as “not rated” in the table below. The credit qualifying ratings for investments held by the component units at June 30, 2008 are as follows (expressed in thousands):

	Fair value			Investment rating		
	Unrestricted	Restricted	Total	AAA to A	BBB+	Not rated
Mortgage-backed securities	\$ 192,338	1,163,175	1,355,513	1,350,355	—	5,158
US government and agency securities	436,783	1,605,905	2,042,688	509,277	1,459,763	73,648
US-sponsored agencies notes	502,629	739,850	1,242,479	1,242,479	—	—
Negotiable certificates of deposit	151,868	409,274	561,142	531,014	—	30,128
US corporate stocks	62,325	—	62,325	—	—	62,325
Non-US corporate stocks	18,455	23,343	41,798	21,493	—	20,305
US corporate bonds	532,593	75,496	608,089	496,145	105,380	6,564
Commercial paper	26,850	—	26,850	26,850	—	—
Puerto Rico agencies and municipal bonds	205,067	1,306,763	1,511,830	13,086	1,498,595	149
Money market fund	164,901	48,661	213,562	213,461	—	101
Guarantee investment contract	369,686	1,244,933	1,614,619	1,548,603	36,708	29,308
P.R. Government Investment Trust Fund	70,119	—	70,119	69,595	—	524
Investment pool	2,073,038	359,373	2,432,411	2,230,964	58,194	143,253
Security lending transactions	143,311	—	143,311	96,267	—	47,044
Investment in other equity securities	422,258	500	422,758	4,872	—	417,886
Other	472,359	54,799	527,158	1,997	454,319	70,842
Total investments	\$ 5,844,580	7,032,072	12,876,652	8,356,458	3,612,959	907,235



# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

Certain component units classified approximately \$5 million of investments presented in PRGITF as cash and cash equivalents. The following table summarizes the type and maturities of investments held by the component units at June 30, 2008 (expressed in thousands):

	Fair value	Maturity (in years)					Total
		Less than 1 year	1-5 years	6-10 years	More than 10 years	No stated maturity date	
Mortgage-backed securities	\$ 1,355,513	1,277	168,232	173,208	1,012,796	—	1,355,513
US government and agency securities	2,042,688	50,984	174,134	48,635	1,695,339	73,596	2,042,688
US-sponsored agencies notes	1,242,479	54,756	836,929	25,508	325,286	—	1,242,479
Negotiable certificates of deposit	561,142	561,014	—	—	—	128	561,142
US corporate stocks	62,325	—	7,691	—	—	54,634	62,325
Non-US corporate stocks	41,798	—	—	—	—	41,798	41,798
US corporate bonds	608,089	102,005	219,971	128,318	82,837	74,958	608,089
Commercial paper	26,850	26,850	—	—	—	—	26,850
Puerto Rico agencies and municipal bonds	1,511,830	92,809	373,097	405,719	640,205	—	1,511,830
Money market fund	213,562	164,407	—	—	—	49,155	213,562
Guaranteed investment contract	1,614,619	698,752	29,308	—	724,575	161,984	1,614,619
P.R. Government Investment Trust Fund	70,119	38,572	—	—	—	31,547	70,119
Investment pool	2,432,411	2,289,158	—	—	—	143,253	2,432,411
Security lending transactions	143,311	96,267	—	—	—	47,044	143,311
Investment in other equity securities	422,758	—	—	—	—	422,758	422,758
Other	527,158	181,316	275,000	—	54,799	16,043	527,158
Total	\$ 12,876,652	4,358,167	2,084,362	781,388	4,535,837	1,116,898	12,876,652

Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay the obligation with or without call or prepayment penalties.

The component units were exposed to the following custodial credit risk for investments held at June 30, 2008 (expressed in thousands):

Insured or registered	\$ 1,133,508
Uninsured and registered, with securities held by the counterparty's trust department or agent in the component units' name	11,586,418
Uninsured and unregistered, with securities held by the counterparty's trust department or agent, but not in the component units' name	156,726
Total	\$ 12,876,652

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

#### Foreign Currency Risk

The State Insurance Fund Corporation (SIFC) limits its exposure to foreign currency risk by limiting the total amount invested to 5% of the portfolio. The SIFC investments denominated in a foreign currency are presented as follow (expressed in thousands):

Investment type	Local currency	Fair value
Money market funds	Canadian dollar	79
	Swedish krone	224
	Euro	160
	Japanese yen	91
		554
Common stocks	British pound	10,504
	Canadian dollar	865
	Danish krone	842
	Euro	18,563
	Hong Kong dollar	1,923
	Japanese yen	16,024
	Norwegian krone	852
	Swedish krone	2,533
	Swiss franc	6,243
		58,349

#### Fiduciary Funds

Cash and cash equivalents of the fiduciary funds at June 30, 2008 consist of the following (expressed in thousands):

	Carrying amount			Bank balance
	Unrestricted	Restricted	Total	
Commercial banks and				
U.S. Treasury	\$ 965,749	—	965,749	964,727
Component unit banks	758,307	1,320,224	2,078,531	2,142,807
Total	\$ 1,724,056	1,320,224	3,044,280	3,107,534

Cash and cash equivalents consist of demand deposits, interest-bearing accounts, certificates of deposit, and bank investment contracts.

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

### ***Custodial Risk***

Custodial credit risk is the risk that, in the event of a bank failure, the fiduciary funds' deposits might not be recovered. The Commonwealth requires that public funds deposited in commercial banks in Puerto Rico must be fully collateralized for the amount deposited in excess of federal depository insurance. All securities pledged as collateral are held by the Secretary of the Treasury of the Commonwealth. There is no formal policy for custodial credit risk for cash accounts opened with commercial banks outside of Puerto Rico.

The Commonwealth was exposed to the following custodial credit risk arising from the balance of deposits maintained by the fiduciary funds in commercial and component unit banks at June 30, 2008 (expressed in thousands):

Uninsured and uncollateralized	\$	2,142,807
Uninsured and collateralized, with securities held by the pledging financial institutions		<u>964,727</u>
Total	\$	<u><u>3,107,534</u></u>

### ***Foreign Currency Risk***

Cash exposed to foreign currency risk as of June 30, 2008 is as follows (expressed in thousands):

Investment type	Currency	Fair value at U.S. dollar currency
Cash	Euro	\$ 2,446
Cash	Norwegian Krone	1,985
Cash	British pound	560
Cash	Japanese yen	102
Cash	Hong Kong dollar	<u>6</u>
		\$ <u><u>5,099</u></u>

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

### Investments

The investment policies of the pension trust funds limit the investment in corporate debt securities to the top rating issued by nationally recognized credit rating organizations. The portfolio is expected to maintain a minimum weighted average credit quality of either “A” or better using either Standard and Poor’s or Moody’s credit ratings. The following table summarizes the fair value by investment type and maturities of investments held by the pension trust and special deposit agency funds at June 30, 2008 (expressed in thousands):

Investments type	Less than 1 year	1 – 5 years	6 – 10 years	More than 10 years	No stated maturity date	Fair value
Non-U.S. equity securities	\$ —	—	—	—	1,129,718	1,129,718
U.S. equity securities	—	—	—	—	2,755,193	2,755,193
U.S. government and agencies securities	6,791	57,685	38,624	471,845	—	574,945
U.S. corporate debt securities	11,079	133,825	123,152	207,962	—	476,018
Limited partnership/private equity	—	—	—	—	79,924	79,924
Other	—	—	—	—	41,402	41,402
Total	\$ 17,870	191,510	161,776	679,807	4,006,237	5,057,200

Expected maturities will differ from contractual maturities, because borrowers may have the right to call or prepay obligations with or without call or prepayment penalties.

The following table summarizes the credit quality ratings for investments held by the pension trust and special deposits agency funds at June 30, 2008 (expressed in thousands):

Investments type	Fair value	AAA to A	BBB+	Not rated
Non-U.S. equity securities	\$ 1,129,718	—	—	1,129,718
U.S. equity securities	2,755,193	—	—	2,755,193
U.S. government and agencies securities	574,943	571,236	627	3,080
U.S. corporate debt securities	476,020	341,428	134,362	230
Limited partnership/private equity	79,924	—	—	79,924
Other	41,402	—	—	41,402
Total	\$ 5,057,200	912,664	134,989	4,009,547

At June 30, 2008, securities investments amounting to \$5 billion were registered in the name of the pension trust funds and were held in the possession of the pension’s trust funds custodian banks.

The investment in non-U.S. stocks is expected to achieve long-term, aggressive capital appreciation by investing in Core EAFE (Europe Australasia and the Far East) securities. The portfolio is expected to be broadly diversified with respect to exposures to countries, economic sectors, industries, and individual stock. No single issue is expected to exceed 5% (at fair value) of the portfolio.

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

Investments exposed to foreign currency risk as of June 30, 2008 are as follows (expressed in thousands):

Investment type	Currency	Fair value at U.S. dollar currency
Depository receipts	Commingled fund	\$ 258,636
Equity securities	Euro	207,248
Equity securities	Japanese yen	165,313
Equity securities	Pound	87,524
Equity securities	Swiss franc	55,589
Equity securities	Pound	52,477
Equity securities	Australian dollar	38,783
Equity securities	Swedish krona	27,899
Equity securities	Norwegian krone	23,265
Equity securities	Hong Kong dollar	21,950
Equity securities	Singapore	16,210
Equity securities	Brazil real	6,650
Equity securities	Danish krone	5,720
Mutual funds	Pound	5,273
Equity securities	Russia rubles	5,041
Equity securities	Taiwan new dollars	3,754
Equity securities	Poland zlotych	3,647
Equity securities	Swiss francs	3,462
Equity securities	China yuan renmimbi	2,467
Equity securities	Denmark kroner	2,360
Equity securities	India rupees	1,180
Equity securities	Mexico pesos	1,126
Equity securities	Indonesia rupiahs	965
Equity securities	Malasya ringgits	429
Equity securities	Africa rand	429
Equity securities	Turkey lira	107
Equity securities	Philippines pesos	107
Equity securities	South Korea won	107
Equity securities	New Zealand dollar	54
		<u>\$ 997,772</u>

### (7) Securities Lending Transactions

During the year, the pension trust funds, included within the fiduciary funds, SIFC and AACA, two discretely presented component units, entered into securities lending transactions. These transactions are explained below:

#### Pension Trust Funds

The Retirements System participates in a security lending program whereby securities are transferred to an independent broker or dealer in exchange for collateral in the form of cash, government securities, and



# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

irrevocable bank letters of credit equal to approximately 102% of the market value of the domestic securities on loan and 105% of the market value of the international securities on loan, with a simultaneous agreement to return the collateral for the same securities in the future. Collateral is marked to market daily, and the agent places a request for additional collateral from brokers if needed. The custodian bank is the agent for the securities lending program.

Securities lending obligations for which collateral was received as of June 30, 2008 consist of the following (expressed in thousands):

<b>Securities lent</b>	<b>Fair value of underlying securities</b>
U.S. corporate debt securities	\$ 26,336
U.S. government securities	51,047
U.S. equity securities	209,605
Non-U.S. equity securities	44,628
	<u>\$ 331,616</u>

The collateral received amounted to approximately \$449.4 million. The collateral securities cannot be pledged or sold unless the borrower defaults; therefore, these transactions are not reported as assets and liabilities in the statements of fiduciary net assets. Collateral received was invested as follows (expressed in thousands):

<b>Collateral</b>	<b>Fair value</b>
U.S. government securities	\$ 1,191
Commercial paper	133,613
Certificate of deposit	57,368
Corporate bonds	16,801
Bank note	40,322
Treasury deposits	5,163
Repurchase agreements	6,529
Asset backed commercial paper	13,386
Reverse repurchase agreement U.S. agency delivered	1,068
Reverse repurchase agreement U.S. mortgage-backed triparty	174,000
	<u>\$ 449,441</u>

The relationship between the investment maturities and the Retirement Systems' loans cannot be determined.

At year-end, the Retirement Systems have no credit risk exposure to borrowers because the amounts that the Retirement Systems owe the borrowers exceed the amounts the borrowers owe to the Retirement Systems. The Retirement Systems' rights to collateral are defined in the contractual agreements. The borrower's creditworthiness is also proactively reviewed by the lending agent.

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

### Component Units

#### SIFC

The Commonwealth statutes and the SIFC's board of directors' policies permit SIFC to use its investments to enter into securities lending transactions. The SIFC's securities custodian, as agent of SIFC, manages the securities lending program and receives cash, securities, or irrevocable bank letters of credit as collateral. The collateral securities cannot be pledged or sold by SIFC unless the borrower defaults. The collateral requirement is equal to 102% for securities issued in the United States of America and 105% for securities issued outside of the United States of America of the fair value of the securities lent. Additional collateral has to be provided by the next business day if its value falls to less than 100% of the fair value of the securities lent. At year-end, SIFC has no credit risk exposure to borrowers because the amounts SIFC owes the borrowers exceed the amounts the borrowers owe SIFC. Contracts with the lending agents require them to indemnify SIFC if the borrowers fail to return the securities (and if the collateral is inadequate to replace the securities lent) or fail to pay SIFC for income distributions by the securities' issuers while the securities are on loan.

All security loans can be terminated on demand by either SIFC or the borrower, although the average term of the loans is two weeks. In lending securities, the term to maturity of the securities loans is matched with the term to maturity of the investment of the cash collateral. Such matching existed at year-end. Securities lending obligations for which cash was received as collateral as of June 30, 2008 consist of the following (expressed in thousands):

Securities lent	Fair value of underlying securities
Equity securities	\$ 39,104
U.S. government, agencies, and instrumentalities obligations	31,835
Corporate bonds and notes	22,263
	<u>\$ 93,202</u>

Cash collateral received amounted to \$96 million and it was invested in repurchase agreements. These secured lending activities are included in the accompanying statement of net assets, since cash was received as collateral but reinvested as explained above.

In addition, SIFC had the following securities lending obligations collateralized by securities as of June 30, 2008 (expressed in thousands):

Securities lent	Fair value of underlying securities	Securities collateral received
U.S. government, agencies, and instrumentalities obligations	\$ 51,438	52,460

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

These securities lending transactions are collateralized by securities that cannot be pledged or sold unless the borrower defaults; therefore, they are not reported as assets and liabilities in the accompanying balance sheets.

### AACA

AACA lends securities to broker/dealers and other entities (borrowers) for collateral that will be returned in the future for the same securities. The custodial bank manages the securities lending program and receives cash, government securities, and letters of credit as collateral. The program provides for an initial minimum collateralization of 102% of the market value of the securities lent plus accrued income. Additional collateral has to be provided by the close of the next business day if its value falls to less than 100%. The contract with the custodial bank requires that should a collateral deficiency occur beyond the custodian's responsibilities, the deficiency should be allocated pro rata among all client lenders within the program.

Either the custodian bank or the borrower can terminate all security loans at any time. Cash collateral is invested in the program's agent short-term investment pools, which at fiscal year-end had a weighted average maturity of approximately 30 days. The relationship between securities of the investment pool and AACA loans cannot be determined.

The following represents the balances relating to the securities lending transactions as of June 30, 2008 (expressed in thousands):

<b>Securities lent</b>	<b>Fair value of underlying securities</b>	<b>Cash collateral received</b>	<b>Noncash collateral received</b>
U.S. Treasury bills, bonds, and notes	\$ 13,170	13,273	199
Common and preferred stocks	18,958	19,096	425
Corporate bonds	1,674	1,723	—
U.S. agencies bonds and notes	12,633	12,952	—
	<u>\$ 46,435</u>	<u>47,044</u>	<u>624</u>

Secured lending transactions where cash collateral was received and reinvested are presented as assets and liabilities in the accompanying statement of net assets. Securities lending transactions collateralized by noncash collateral cannot be pledged or sold unless the borrower defaults are not reported as assets or liabilities in the statement of net assets. At year-end, AACA has no credit risk exposure to borrowers because the amounts AACA owes the borrowers exceed the amounts the borrowers owe AACA.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

#### (8) Investments in Limited Partnerships

Pursuant to the Statement of Investment Guidelines for the Government of Puerto Rico, the pension trust funds and a component unit invested approximately \$12.6 million in limited partnerships during the year ended June 30, 2008. The investments were as follows:

- During fiscal year 2008, there were \$121,000 of contributions made during fiscal year 2008 in Guayacán Funds of Funds, L.P., a Delaware limited partnership, organized by Grupo Guayacán, Inc. as general partner, which has total commitments of \$55.5 million (of which \$45 million are from pension trust funds and the remaining balances from private corporate investors). This fund invests in the United States of America and international private equity partnerships that in turn invest in private companies.
- During fiscal year 2008, \$255,000 was invested in Guayacán Fund of Funds II, L.P., a Delaware limited partnership, organized by Grupo Guayacán, Inc. as general partner, that has total commitments of \$62 million (of which \$50 million are from the pension trust funds and the remaining balances from private corporate investors). The fund invests in a broad range of United States and international private equity investment partnerships that, in turn, will make equity and equity-related investments primarily in private businesses.
- During fiscal year 2008, there were no contributions in Guayacán Private Equity Fund, L.P., a Delaware limited partnership, organized by Advent-Morro Equity Partners, Inc. as general partner, that has total commitments of \$59 million (of which \$10 million are from the pension trust funds, \$22.5 million are from component units and the remaining balance from the private corporate investors in Puerto Rico). This fund invests in Puerto Rico private equity.
- During fiscal year 2008, \$9.4 million was invested in Guayacán Private Equity Fund, L.P. II, a Delaware limited partnership, organized by Advent/Morro Partners as general partner, that has total commitments of \$64 million (of which \$35 million are from components units, \$15 million are from pension trust funds, and the remaining balance from the private corporate investors in Puerto Rico). This fund invests in Puerto Rico private equity.
- During fiscal year 2008, \$802,448 was invested in Invesco Venture Partnership Fund III, L.P., a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as general partner in which the pension trust fund has a total commitment of \$5.5 million. The partnership was organized to invest in other collective investments funds investing in alternative assets, including primarily United States and international funds that focus on both early- and later-stage venture capital investments.
- During fiscal year 2008, \$92,378 was invested in Invesco Non-U.S. Partnership Fund III, L.P., a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as general partner, in which the pension trust fund has a total commitment of \$4.5 million. The partnership was organized to invest in other collective investments funds investing in alternative assets, including primarily investments focusing on non-U.S. buyouts, expansion capital, turnaround, mezzanine, and distressed investment partnership.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

- During fiscal year 2008, \$202,272 was invested in Invesco U.S. Buyout & Expansion Capital Partnership Fund III, L.P., a Delaware limited partnership, organized by IPC Partnership Associates III, LLC as general partner, in which the pension trust fund has a total commitment of \$3.7 million. The partnership was organized to invest in other collective funds investing in alternative assets, including primarily investments focusing on small, mid-size, and large domestic buyout transactions.
- During fiscal year 2008, \$197,863 was invested in Chase Capital Partners Private Equity Fund of Funds II, LTD, a limited partnership, organized by Chase as general partner, in which the pension trust fund has a total commitment of \$15 million. The fund's investment strategy is to capitalize on a globally diversified portfolio of private equity investments opportunities across various sectors, including buyouts, growth equity, venture capital, and other special situations through partnership, investments, and direct investments.
- During fiscal year 2008, there were no additional contributions to Venture Capital Fund, Inc., a Puerto Rico Corporation, organized pursuant to Act No. 3 of October 6, 1987, as amended, known as the Puerto Rico Capital Investment Funds Act that is managed by Advent-Morro Equity Partners (Advent-Morro Equity Partners, Inc.) in which the pension trust fund has a total commitment of \$800,000. Advent-Morro is a Puerto Rico based private equity firm. The fund was created to make private equity investments in operating companies that are based, or are operating or a combination of both, in Puerto Rico. Since inception, the fund has invested in 25 companies some of which it continues to provide capital for their expansion.
- During fiscal year 2008, \$1.5 million was invested in GF Capital Private Equity Fund, L.P., a limited partnership, organized under the laws of the State of Delaware, in which the pension trust fund has a total commitment of \$25 million. The purpose of the partnership is to make private equity investments in a variety of industries including media and entertainment, branded consumer products, and software for media and telecommunications applications. The partnership initiatives are focused on companies capitalized at between \$20 million and \$400 million with a representation of buyouts, growth capital, and recapitalizations.
- During fiscal year 2008, \$395 thousand was invested in Chase Capital Partners Private Equity Fund of Funds Corporate Investors II, LTD, a limited partnership, organized by Chase as general partner in which the pension trust fund has a total commitment of \$20 million. The fund's investment strategy is to capitalize on a globally diversified portfolio of private equity investment opportunities across various sectors including buyouts, growth equity, venture capital, and other special situations through partnership and direct investments.

The fair value of these investments at June 30, 2008 amounted to \$79.9 million and is presented within investments in the statement of fiduciary net assets. The fair values of these investments have been estimated by the corresponding general partner or fund manager of these partnerships and disclosed in its respective separate audited financial statements. The allocations of net gain and net loss to the limited partners are based on certain percentages, as established in the limited partnership agreements. The difference between the fair value of the investments and the total cumulative contributions is mostly due to distributions made.



**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

As of June 30, 2008, the pension trust funds and discretely presented component units had capital commitments and contributions as follows (expressed in thousands):

	<u>Public sector commitments</u>	<u>Fiscal year contributions</u>	<u>Cumulative contributions</u>
<b>Guayacán Funds of Funds, L.P.</b>			
Primary government:			
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	\$ 25,000	67	23,570
Puerto Rico System of Annuities and Pensions for Teachers	20,000	54	18,857
Subtotal	45,000	121	42,427
<b>Guayacán Funds of Funds II, L.P.</b>			
Primary government:			
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	25,000	127	23,538
Puerto Rico System of Annuities and Pensions for Teachers	25,000	128	23,539
Subtotal	50,000	255	47,077
<b>Guayacán Private Equity Fund, II, L.P.</b>			
Primary government:			
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	5,000	—	4,407
Puerto Rico System of Annuities and Pensions for Teachers	5,000	—	4,407
Component unit:			
Economic Development Bank for Puerto Rico	20,000	—	17,625
UPR Employees Retirement System	2,500	—	2,203
Subtotal	32,500	—	28,642
Balance carried forward	127,500	376	118,146

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

	<u>Public sector commitments</u>	<u>Fiscal year contributions</u>	<u>Cumulative contributions</u>
Balance brought forward	\$ 127,500	376	118,146
<b>Guayacán Private Equity Fund, L.P. II</b>			
Primary government:			
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	15,000	4,365	5,565
Component unit:			
Economic Development Bank for Puerto Rico	20,000	2,852	4,452
State Insurance Fund Corporation	10,000	1,426	2,226
UPR Employees Retirement System	5,000	713	1,113
Subtotal	50,000	9,356	13,356
<b>Other Funds</b>			
Primary government:			
Employees' Retirement System of the Government of Puerto Rico and its Instrumentalities	45,800	1,895	23,021
Puerto Rico System of Annuities and Pensions for Teachers	28,700	1,294	25,981
Subtotal	74,500	3,189	49,002
Total	\$ 252,000	12,921	180,504

### (9) Receivables and Payables

Receivables in the governmental funds include approximately \$1.3 billion of accrued income, excise and sales and use taxes. Intergovernmental receivables are \$240 million receivable from the federal government and \$25 million from the Municipal Revenue Collection Center (CRIM for its Spanish acronym). In addition, the enterprise funds include \$56.4 million of unemployment, disability, and drivers' insurance premium receivable.

Payables in the governmental funds include approximately \$896 million of trade accounts due to suppliers for purchase of merchandise and services rendered and \$245 million of tax refunds payable. Also at June 30, 2008, excess of checks drawn over the pooled bank balance amounted to approximately \$960 million and is reported within accounts payable and accrued liabilities of the governmental activities.

In accordance with GASB Technical Bulletin No. 2004-1, *Tobacco Settlement Recognition and Financial Reporting Entity Issues* (the TB), a receivable of \$38.3 million was recorded as other receivables in the government-wide financial statements for estimated shipments from January 1 to June 30, 2008, which will be applied to debt service upon collection. Additionally, the TB indicated that the Trust designated as the Tobacco Settlement Authority (TSA) should recognize a liability for the bonds payable and an expense

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

(and liability if unpaid) in the same period in its stand-alone financial statements. The expense (and liability if unpaid) recognizes the contractual obligation to remit the proceeds of the bond sold. Since the Trust is reported as a blended component unit, the TB indicates these remittances should be reported as transfers into the fund receiving the proceeds and transfers out in the fund that accounts for the activities of the TSA. Since the Trust has no contractual obligation, under its enabling legislation or elsewhere, to remit all bond proceeds or assets related to the GSA to the settling government (the Commonwealth), the Trust has not recognized an expense and liability for unpaid proceeds from the bonds since it records the expense as amounts are disbursed as grants to its settling government (including its instrumentalities) or third parties.

#### (10) Pledges of Receivables and Future Revenues

GASB Statement No. 48, *Sales and Pledges of Receivables and Future Revenues and Intra-Entity Transfer of Assets and Future Revenues*, establishes criteria that governments will use to ascertain whether the proceeds received from the sale and pledge of receivables and future revenues should be reported as revenue or as a liability. Also, this Statement includes a provision that governments should not revalue assets that are transferred between financial reporting entity components. This Statement is effective for the year ended June 30, 2008.

The Commonwealth has pledged the first one percent of the sales and use tax for the repayment of certain outstanding obligations of the Commonwealth, generally referred to as the extra-constitutional debt. During 2008, the Puerto Rico Sales Tax Financing Corporation (the COFINA), an independent governmental instrumentality, responsible for the financing, payments, and retirement of the extra-constitutional debt, issued bonds in the amounts of approximately \$5,238 million payable through 2058. The Commonwealth has committed to appropriate each year, from the sales and use tax, amounts sufficient to cover the principal and interest requirements on the debt issued by COFINA. COFINA has pledged as the sole security for the bonds, the annual appropriations for the Commonwealth. Total principal and interest remaining on the secured debt is \$5.2 billion. The pledged sale and use tax base amount for the fiscal year ended June 30, 2008 amounted to \$185 million. For fiscal year 2008, principal and interest paid by COFINA and the sales and use tax revenue recognized by the Commonwealth was \$296 million.

#### (11) Interfund and Intraentity Transactions

Interfund receivables and payables at June 30, 2008 are summarized as follows (expressed in thousands):

Receivable fund	Payable fund	Amount
Nonmajor governmental	General	\$ 183,158
General	PBA capital projects	15,000
General	Unemployment insurance	13,632
General	Lotteries	40,839
Capital projects	General	32,167
Lotteries	General	60,424
		\$ 345,220

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

Transfers from (to) other funds for the year ended June 30, 2008 are summarized as follows (expressed in thousands):

<b>Transferee fund</b>	<b>Transferor fund</b>	<b>Amount</b>
General	Unemployment insurance	\$ 116,151
Nonmajor governmental	General	211,285
PBA capital projects	General	90,608
PBA capital projects	Nonmajor governmental	117,692
General	Lotteries	203,273
Debt service	General	242,236
General	The Children's Trust special revenue	190,000
General	Capital projects	131,637
General	Nonmajor enterprise	12,800
Nonmajor enterprise	General	11,524
The Children's Trust special revenue	Nonmajor governmental	243
		<u>\$ 1,327,449</u>

The principal purposes of the interfund transfers are to (express in thousands):

1. Unemployment insurance fund's distribution of surplus cash belonging to the general fund for the payment of administrative expenses (\$116,151).
2. Recognize as transfers the rental payments made by the Commonwealth's agencies on properties leased by PBA, a blended component unit of the Commonwealth (\$211,285) to the nonmajor funds of PBA and \$90,608 to the PBA capital project fund.
3. Distribute the increase in net assets of the lotteries fund for the use of the general fund, as required by the lotteries enabling legislation (\$203,273). Make funds available for debt service payments in the debt service fund (\$242,236).
4. Make funds available for debt service payments from the PBA's Capital project fund to the PBA's debt service fund (\$117,692).
5. Transfer from The Children's Trust special revenue fund to the general fund in order to provide financial assistance to carry out project aimed at promoting the well-being of children and youth of Puerto Rico (\$190,000).
6. Transfer from the capital project fund for repayment of the general fund's lines of credit, pursuant to such line-of-credit agreement (\$131,637).
7. Transfer of \$12,800 from the disability insurance fund to the unemployment insurance fund for a reimbursement representing an excess matching contribution corresponding to previous years.
8. To provide local matching funds from the general fund related to the federal capital grants of the Puerto Rico Water Pollution Revolving Fund and Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund, two nonmajor enterprise funds of the Commonwealth (\$11,524).

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

9. Transfer of \$243 from the tobacco settlement asset-backed bonds debt service fund to The Children's Trust special revenue fund in order to provide funds for operating expenses.

Interfund receivables and payables represent the pending settlements of the aforementioned transfers or transactions from current and prior years.

Due from (to) primary government and component units are as follows (expressed in thousands):

<u>Receivable entity/fund</u>	<u>Amount</u>	<u>Payable entity/fund</u>	<u>Amount</u>
Business-type activities	\$ 293,290	Puerto Rico Aqueduct and Sewer Authority	\$ 293,290
		Puerto Rico Health Insurance Administration	7,239
		Nonmajor component units:	
		Puerto Rico Medical Services Administration	52,654
		Cardiovascular Center Corporation of Puerto Rico and the Caribbean	43,189
		Puerto Rico Tourism Company	13,567
		Employment and Training Enterprises Corporation	7,108
		Governing Board of the 911 Service	6,194
Governmental activities	<u>129,951</u>		<u>6,194</u>
	\$ <u>423,241</u>		\$ <u>423,241</u>
Puerto Rico Electric Power Authority	\$ 195,780	Governmental activities	\$ 438,033
University of Puerto Rico	96,770		
Puerto Rico Health Insurance Administration	65,930		
Nonmajor component units:			
Puerto Rico Industrial Development Company	45,893		
Puerto Rico Medical Services Administration	18,718		
Puerto Rico Conservatory of Music Corporation	8,389		
Land Authority of Puerto Rico	<u>6,553</u>		
	\$ <u>438,033</u>		\$ <u>438,033</u>

The amount owed by PRASA of \$293 million represents construction loans granted by the Puerto Rico Water Pollution Control Revolving Fund and the Puerto Rico Safe Drinking Water Treatment Revolving Loan Fund, nonmajor enterprise funds, to finance the construction of capital assets for PRASA.



# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

The amount receivable by PREPA of \$195.8 million from the primary government represents amounts due from primary governments related to electric and related service provided to primary government.

The amount receivable by UPR of \$96.8 million from the primary government represents amounts due from primary governments related to appropriations grants and contracts.

Due from (to) component units are as follows (expressed in thousands):

Receivable entity/fund	Amount	Payable entity/fund	Amount
Puerto Rico Ports Authority	\$ 25,833	Puerto Rico Medical Services Administration	\$ 32,145
University of Puerto Rico	23,381	University of Puerto Rico	9,704
Puerto Rico Electric Power Authority	17,970	Nonmajor component units:	
Nonmajor component units:		Agricultural Services and Development Administration	26,250
Land Authority of Puerto Rico	19,075	Puerto Rico Maritime Transportation Authority	25,833
Farm Insurance Corporation of Puerto Rico	13,206	Cardiovascular Center Corporation of Puerto Rico and the Caribbean	9,206
Puerto Rico Medical Services Administration	9,704	Farm Insurance Corporation of Puerto Rico	6,031
Puerto Rico Convention Center District Authority	5,500	Puerto Rico Tourism Company	5,500
State Insurance Fund Corporation	3,500	Puerto Rico Solid Waste Authority	3,500
Puerto Rico Land Administration	2,496	Puerto Rico Industrial Development Company	2,496
	<u>120,665</u>		<u>120,665</u>

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

<u>Receivable entity/fund</u>	<u>Amount</u>	<u>Payable entity/fund</u>	<u>Amount</u>
Governmental Development Bank for Puerto Rico	\$ 1,570,755	Puerto Rico Electric Power Authority	\$ 113,065
		Puerto Rico Aqueduct and Sewer Authority	109,472
		Puerto Rico Sales Tax Financing Corporation	104,528
		Puerto Rico Highways and Transportation Authority	83,571
		University of Puerto Rico	51,128
		Nonmajor component units:	
		Special Communities Perpetual Trust	376,095
		Puerto Rico Convention Center District	150,739
		Puerto Rico Land Administration	145,207
		Agricultural Services and Development Administration	127,578
		Puerto Rico Industrial Development Company	91,681
		Land Authority of Puerto Rico	53,050
		Puerto Rico Solid Waste Authority	52,394
		Puerto Rico Ports Authority	39,855
		Puerto Rico Infrastructure Financing Authority	24,511
		Institute of Puerto Rican Culture	17,690
		Economic Development Bank for Puerto Rico	11,524
		Puerto Rico Municipal Finance Agency	11,073
		National Parks Company of Puerto Rico	7,594
			<u>1,570,755</u>
	<u>\$ 1,691,420</u>		<u>\$ 1,691,420</u>

The rest of the loans receivable reported by GDB consists of the following (expressed in thousands):

Primary government – governmental activities	\$ 2,085,488
Other governmental entities and municipalities	991,399
Private sector	815,777
Total loans receivable reported by GDB	<u>\$ 3,892,664</u>

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

The loans to the primary government are presented by the Commonwealth within notes payable in the statement of net assets.

Expenses of the primary government include approximately \$2.5 billion in capital and operational contributions made by the primary government to the component units comprise the following (expressed in thousands):

Puerto Rico Health Insurance Administration	\$	989,386
University of Puerto Rico		893,759
Puerto Rico Infrastructure Financing Authority		91,252
Government Development Bank for Puerto Rico		11,689
Puerto Rico Aqueduct and Sewer Authority		50,610
Nonmajor component units		423,725
Total contributions made by primary government to component units	\$	<u>2,460,421</u>

### (12) Restricted Assets

Restricted assets of the primary government included in the basic financial statements at June 30, 2008 consist of cash, investments, and other assets to be used for the following purposes (expressed in thousands):

Governmental activities:		
Debt service and sinking fund	\$	1,199,463
Public Housing Administration – funds received from the U.S. Housing and Urban Development		367,871
Affordable housing program		30,362
Construction of governmental facilities		150,568
Other		143,260
	\$	<u>1,891,524</u>
Business-type activities:		
Investment held for disability insurance benefits	\$	<u>34,637</u>

# **COMMONWEALTH OF PUERTO RICO**

## Notes to Basic Financial Statements

June 30, 2008

Liabilities of the primary government payable from restricted assets consist of the following (expressed in thousands):

Governmental activities:	
Tax revenue anticipation notes	\$ 1,010,000
Interest payable	28,497
Current portion of Public Housing Administration bonds payable	23,505
Accounts payable to contractors	93,001
Other	15,000
	<hr/>
Liabilities payable from restricted assets – governmental activities	\$ 1,170,003
	<hr/>
Business-type activities:	
Insurance benefits payable	\$ 834
	<hr/>
Liabilities payable from restricted assets – business-type activities	\$ 834
	<hr/>

Restricted net assets of the primary government consist of the following (expressed in thousands):

Governmental activities:	
Restricted for capital project	\$ 293,828
Restricted for debt service	99,042
Other purposes	328,651
	<hr/>
Total restricted net assets – governmental activities	\$ 721,521
	<hr/>
Business-type activities:	
Restricted for insurance benefits	\$ 33,803
	<hr/>
Total restricted net assets – business-type activities	\$ 33,803
	<hr/>

Restricted assets of the component units included in the basic financial statements at June 30, 2008 are to be used for the following purposes (expressed in thousands):

Debt service and sinking fund requirements	\$ 5,825,596
Construction and betterments funds	1,760,320
Collateral for underlying securities	999,000
Other uses	430,118
Educational fund	10,004
Malpractice insurance fund	13,197
Maintenance reserve fund	17,003
Industrial incentives	12,343
Escrow	148
	<hr/>
Total for components units	\$ 9,067,729
	<hr/>

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

**(13) Capital Assets**

Capital assets activity for the year ended June 30, 2008 is as follows (expressed in thousands):

***Primary Government***

	<b>Beginning balance (as restated)</b>	<b>Increases</b>	<b>Decreases</b>	<b>Ending balance</b>
Governmental activities:				
Capital assets, not being depreciated:				
Land	\$ 844,533	10,989	4,167	851,355
Construction in progress	1,434,978	301,192	264,254	1,471,916
Total capital assets, not being depreciated	2,279,511	312,181	268,421	2,323,271
Capital assets, being depreciated:				
Buildings and building improvements	6,925,373	336,234	51,420	7,210,187
Equipment furniture, fixtures, and vehicles	450,110	41,177	10,100	481,187
Infrastructure	441,500	4,000	11,703	433,797
Total capital assets, being depreciated	7,816,983	381,411	73,223	8,125,171
Less accumulated depreciation for:				
Buildings and building improvements	2,375,189	194,532	33,188	2,536,533
Equipment furniture, fixtures, and vehicles	224,060	40,185	5,734	258,511
Infrastructure	92,781	8,910	—	101,691
Total accumulated depreciation	2,692,030	243,627	38,922	2,896,735
Total capital assets, being depreciated, net	5,124,953	137,784	34,301	5,228,436
Governmental activities capital assets, net	\$ 7,404,464	449,965	302,722	7,551,707



**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

	<u>Beginning balance</u>	<u>Increases</u>	<u>Decreases</u>	<u>Ending balance</u>
Business-type activities:				
Total capital assets, being depreciated – equipment	\$ 4,810	—	—	4,810
Less accumulated depreciation of equipment	<u>4,136</u>	<u>—</u>	<u>—</u>	<u>4,136</u>
Total business-type activities capital assets, being depreciated, net	<u>\$ 674</u>	<u>—</u>	<u>—</u>	<u>674</u>

Depreciation expense was charged to functions/programs of the primary government for the year ended June 30, 2008 as follows (expressed in thousands):

Governmental activities:	
General government	\$ 79,184
Public safety	24,702
Health	7,966
Public housing and welfare	86,707
Education	30,338
Economic development	<u>14,730</u>
Total depreciation expense – governmental activities	<u>\$ 243,627</u>

The net book value of capital assets of the primary government as of beginning of the year was increased to properly record capital assets amounting to approximately \$3.4 million.

The Commonwealth follows the provision of GASB Statement No. 42, *Accounting and Financial Reporting for Impairment of Capital Assets and for Insurance Recoveries*, an amendment to GASB Statement No. 34. This statement establishes guidance for accounting and reporting for the impairment of capital assets and for insurance recoveries. The Commonwealth recognized an impairment loss of \$16.5 million and \$15.5 million in the statement of activities, related to the reduction in use of educational facilities and environmental resources, respectively.

## **COMMONWEALTH OF PUERTO RICO**

### **Notes to Basic Financial Statements**

June 30, 2008

General infrastructure assets include \$417 million representing the estimated cost of assets transferred to the Department of Natural and Environmental Resources (DNER) of the Commonwealth in 1997 upon completion of the Cerrillos Dam and Reservoir and the Portugues-River and Bucana-River Projects by the U.S. Army Corps of Engineers. These infrastructure assets are reported within governmental activities and include dams, intake facilities, and similar items built for flood control, water supply, and recreational purposes. The Commonwealth also recorded a payable due to the U.S. Army Corps of Engineers, amounting to \$205 million, for its estimated allocated share of the construction costs associated with these projects, including accrued interest of \$5 million. The final debt agreement between DNER and the U.S. Army Corps of Engineers has not been finalized, and therefore, terms and conditions could differ from those estimated. The depreciation is computed using the straight-line method over an estimated useful life of 50 years from the transfer date of the property. The related debt is expected to be payable on an annual basis over a 50-year period. However, the debt has been presented as a long-term payable due after one year in the accompanying statement of net assets since the commencement date of repayment has not yet been determined.

On August 17, 2001, the Legislature of the Commonwealth approved Act No. 120, which requires the conditional transfer of the ownership of certain real properties under the name of the Department of Recreation and Sports (DRS) of the Commonwealth to the municipalities of the Commonwealth. The land and the facilities were transferred at no cost to the municipalities. During fiscal year ended June 30, 2008, land, building, and building improvements with a total carrying amount of \$4.4 million were transferred to several municipalities and recorded as an expense in the accompanying statement of activities.

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

*Discretely Presented Component Units (expressed in thousands)*

	<b>Beginning balance (as restated)</b>	<b>Increases</b>	<b>Decreases</b>	<b>Ending balance</b>
Capital assets, not being depreciated:				
Land	\$ 2,680,907	259,869	29,933	2,910,843
Art works	8,454	863	—	9,317
Construction in progress	6,390,599	2,124,236	1,514,805	7,000,030
Total capital assets, not being depreciated	9,079,960	2,384,968	1,544,738	9,920,190
Capital assets, being depreciated:				
Buildings and buildings improvements	9,289,549	226,876	102,856	9,413,569
Equipment, furniture, fixtures, and vehicles	1,683,857	188,258	59,597	1,812,518
Infrastructure	23,646,467	1,170,696	838	24,816,325
Total capital assets, being depreciated	34,619,873	1,585,830	163,291	36,042,412
Less accumulated depreciation for:				
Buildings and buildings improvements	1,407,608	389,841	62,331	1,735,118
Equipment, furniture, fixtures, and vehicles	1,671,848	92,987	48,020	1,716,815
Infrastructure	12,826,315	507,758	—	13,334,073
Total accumulated depreciation	15,905,771	990,586	110,351	16,786,006
Total capital assets, being depreciated, net	18,714,102	595,244	52,940	19,256,406
Capital assets, net	\$ 27,794,062	2,980,212	1,597,678	29,176,596

The restatements in the beginning balance of capital assets of approximately \$24.4 million are related to several component units sustaining restatements described in note 4.

**(14) Tax Revenue Anticipation Notes Payable**

Tax revenue anticipation notes (TRANS) reported in the general fund were issued on October 18, 2007 at an interest rate of 4.25% and were paid on July 30, 2008. The TRANS amounted to \$1,010 million at June 30, 2008 plus accrued interest of approximately \$27 million. The proceeds of the TRANS were used to cover temporary cash deficiencies resulting from the timing differences between tax collections and the payment of current expenditures.

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic financial Statements

June 30, 2008

**(15) Short- and Long-Term Obligations**

**Primary Government**

**(a) Summary of Short- and Long-Term Obligations**

Short- and long-term obligations at June 30, 2008 and changes for the year then ended are as follows (expressed in thousands):

Short-Term Obligations	Balance at June 30, 2007	Debt issued	Capitalized interest	Debt paid	Original issue (discounts) premiums	Other net increases	Balance at June 30, 2008	Due within one year
Governmental activities:								
Notes payable to component units:								
GDB (short term)	\$ 299,075	308,100	—	(252,989)	—	—	354,186	354,186
Long-Term Obligations	Balance at June 30, 2007	Debt issued	Capitalized interest	Debt paid	Original issue (discounts) premiums	Other net increases (decreases)	Balance at June 30, 2008	Due within one year
Governmental activities:								
General obligation and revenue bonds	\$ 13,034,402	3,677,409	40,274	(2,758,148)	103,471	(105,971)	13,991,437	90,245
Commonwealth appropriation bonds	2,563,392	—	3,207	(1,793,284)	(1,424)	57,436	829,327	—
Qualified Zone Academy Bonds	184,124	—	—	(184,124)	—	—	—	—
Notes payable to component units:								
GDB	3,123,062	330,194	—	(1,721,954)	—	—	1,731,302	146,055
Other	106,866	—	—	(47,455)	—	—	59,411	26,551
Total bonds and notes payable	19,011,846	4,007,603	43,481	(6,504,965)	102,047	(48,535)	16,611,477	262,851
Compensated absences	1,794,115	—	—	(1,068,095)	—	1,042,503	1,768,523	1,054,674
Net pension obligation	5,096,324	—	—	(773,697)	—	1,520,804	5,843,431	—
Net postemployment benefit obligation	—	—	—	—	—	42,373	42,373	—
Obligation under capital lease arrangements	141,811	43,850	—	(4,838)	—	—	180,823	4,570
Other liabilities:								
Employees' Christmas bonus	100,074	—	—	(171,556)	—	174,428	102,946	102,946
Liability for federal cost disallowances	50,159	—	—	—	—	4,232	54,391	—
Liability for legal claims and judgments	950,276	—	—	(23,720)	—	249,328	1,175,884	24,000
Other	205,000	—	—	—	—	—	205,000	—
Total governmental activities	27,349,605	4,051,453	43,481	(8,546,871)	102,047	2,985,133	25,984,848	1,449,041
Business-type activities:								
Compensated absences	5,997	—	—	(1,045)	—	1,259	6,211	2,486
Obligation for unpaid lottery prizes	292,290	—	—	(190,689)	—	186,127	287,728	67,650
Claims liability for insurance benefits	57,915	—	—	(288,623)	—	345,283	114,575	114,575
Total business-type activities	356,202	—	—	(480,357)	—	532,669	408,514	184,711
Total governmental and business-type activities	\$ 27,705,807	4,051,453	43,481	(9,027,228)	102,047	3,517,802	26,393,362	1,633,752

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

The balances of general obligation and revenue bonds paid included within other financing uses and principal as reported in the statement of revenue, expenditures, and changes in fund balances – governmental funds may differ from the amounts reported as debt paid in the above table primarily because the above table includes debt paid on general obligation and revenue bonds, which was accrued during the fiscal year 2007 as a fund liability. The prior year fund liability mentioned above amounted to approximately \$229.4 million and was reported as a balance sheet transaction in the fund financial statements in 2007. Also the amount deposited to escrow agent exceeded the bonds refunded by \$164.5 million. The net effect of \$64.9 million is the difference between the debt paid on bonds and notes in the previous table and the payments in the statement of revenues, expenditures and changes in fund balances – governmental funds.

The other net increases in bonds and notes payable consist of deferred losses on refunding, net of amortization, and net amortization of premiums and discounts on bonds. These adjustments did not require any source or use of cash.

Compensated absences, net pension obligation, obligation for unpaid lottery awards, liability for insurance benefits, and other long-term liabilities reflect other net increases (decreases) resulting from adjustments and changes to agree these obligations to their new estimated balances at June 30, 2008.

**(b) *Debt Limitation***

The Constitution of the Commonwealth authorizes the contracting of debts as determined by the Legislature. Nevertheless, the Constitution of the Commonwealth provides that direct obligations of the Commonwealth evidenced by bonds or notes that are backed by the full faith, credit, and taxing power of the Commonwealth will not be issued if the amounts of the principal of, and interest on, such bonds and notes and on all such bonds and notes issued thereafter, which are payable in any fiscal year, together with any amount paid by the Commonwealth in the preceding fiscal year on account of bonds or notes guaranteed by the Commonwealth, exceeds 15% of the average annual revenue raised under the provisions of Commonwealth legislation and deposited into the Treasury (hereinafter internal revenue) in the two fiscal years preceding the then current fiscal year. Section 2, Article VI of the Constitution does not limit the amount of debt that the Commonwealth may guarantee so long as the 15% limitation is not exceeded through payments by the Commonwealth on such guaranteed debt. Internal revenue consists principally of income taxes, property taxes, sales and use taxes, and excise taxes. Certain revenue, such as federal excise taxes on offshore shipments of alcoholic beverages and tobacco products, and customs duties, which are collected by the U.S. government and returned to the Commonwealth, motor vehicle fuel taxes, and license fees, which are allocated to the PRHTA, a discrete component unit, are not included as revenue for the purpose of calculating the debt limit. At June 30, 2008, the Commonwealth is in compliance with the debt limitation requirement. In addition, the portion of the sales and use tax allocated to COFINA is not included as internal revenue in consistency with the legislation creating COFINA, which legislation transfers ownership of such portion of the sales and use tax to COFINA and provides that such portion is not “available resources” under the constitutional provisions relating to the payment of debt service.

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

**(c) Bonds Payable**

The Constitution of the Commonwealth provides that public debt will constitute a first claim on the available revenue of the Commonwealth. Public debt includes general obligations and notes of the Commonwealth and any payment required to be made by the Commonwealth under its guarantees of bonds issued by blended or discretely presented component units. The good faith, credit, and taxing power of the Commonwealth are irrevocably pledged for the prompt payment of the principal and interest of the general obligation bonds.

Act No. 83 of August 30, 1991, as amended, provides for the levy of an annual special tax of 1.03% of the assessed value of all real and personal property not exonerated from taxation. The levy is collected by CRIM, a municipal corporation, not a component unit of the Commonwealth. CRIM is required to remit the 1.03% of property tax collected to the Commonwealth to be used by the Commonwealth's debt service fund for payment of debt service on general obligations of the Commonwealth. During the year ended June 30, 2008, the total revenue and receivable reported by the Commonwealth amounted to approximately \$120 million and \$25 million, respectively, which are included in the debt service fund.

For financial reporting purposes, the outstanding amount of bonds represents the total principal to be repaid, net of unamortized premiums, discount, and deferred refunding losses; for capital appreciation bonds, it represents total principal and accreted interest to be repaid.



**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

Bonds payable outstanding at June 30, 2008 are as follows (expressed in thousands):

	<u>General obligation</u>	<u>Revenue bonds</u>	<u>Total</u>
Term bonds payable through 2036; interest payable semiannually at rates varying from 3% to 8%.	\$ 3,530,535	1,937,625	5,468,160
Serial bonds payable through 2024; interest payable semiannually at rates varying from 3.75% to 7.50%.	5,014,005	1,044,965	6,058,970
Capital appreciation bonds payable through 2031; no interest rate, yield ranging from 4.42% to 7.80%. Net of accreted discount of \$121.6 million.	162,197	100,088	262,285
The Children's Trust Fund tobacco settlement asset-backed bonds payable through 2026; interest payable annually at rates varying from 4.625% to 6.000%.	—	1,413,926	1,413,926
Capital fund program bonds, maturing in various dates payable through 2024; interest payable at rates varying from 2% to 5%.	—	596,335	596,335
Bond payment obligation payable through 2010; interest payable at rates varying from 1.5% to 5.5%.	48,220	—	48,220
Balance carried forward	<u>\$ 8,754,957</u>	<u>5,092,939</u>	<u>13,847,896</u>

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

	<b>General obligation</b>	<b>Revenue bonds</b>	<b>Total</b>
Balance brought forward	\$ 8,754,957	5,092,939	13,847,896
Yield curve bonds payable from 2009 through 2011; no interest rate, yield of 8.914%.	10,300	—	10,300
Yield retail bonds payable from 2009 through 2011; interest payable at rates varying from 2.875% to 5.000%.	10,000	—	10,000
Tax-exempt components maturing through 2007 and 2008; interest payable at rates ranging from 5.5% to 5.6%.	—	37,040	37,040
Inverse rate bonds payable from 2009 through 2011; interest payable at a rate of 6%.	10,300	—	10,300
Insured bonds payable from 2014 through 2018; interest payable at a rate of 5%.	50,085	—	50,085
Total	8,835,642	5,129,979	13,965,621
Unamortized premium, net	256,750	60,456	317,206
Deferred charges arising from debt refunding	(103,346)	(188,275)	(291,621)
Savings bonds	231	—	231
Total bonds payable	\$ 8,989,277	5,002,160	13,991,437

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

During the year ended June 30, 2008, the following changes occurred in the bonds payable (expressed in thousands):

	<b>Outstanding at June 30, 2007</b>	<b>Issued</b>	<b>Premiums/ discount (redemptions)</b>	<b>Outstanding at June 30, 2008</b>
Term bonds	\$ 4,881,680	1,335,940	(1,231,315)	4,986,305
Serial bonds	5,573,820	2,145,590	(1,165,380)	6,554,030
Capital appreciation bonds	383,147	—	(134,067)	249,080
The Children's Trust Fund				
tobacco settlement				
asset-backed bonds	1,234,904	195,879	(16,857)	1,413,926
Capital fund program bonds	619,105	—	(22,770)	596,335
Bond payment obligations	125,910	—	(77,690)	48,220
Yield curve bonds	15,000	—	(4,700)	10,300
Yield retail bonds	21,000	—	(11,000)	10,000
Tax-exempt components	72,160	—	(35,120)	37,040
Inverse rate bonds	79,360	—	(18,975)	60,385
Subtotal	13,006,086	3,677,409	(2,717,874)	13,965,621
Unamortized premium	240,155	103,471	(26,420)	317,206
Deferred charges arising				
from debt refunding	(212,070)	(138,905)	59,354	(291,621)
Savings bonds	231	—	—	231
Total	<u>\$ 13,034,402</u>	<u>3,641,975</u>	<u>(2,684,940)</u>	<u>13,991,437</u>

# **COMMONWEALTH OF PUERTO RICO**

## Notes to Basic Financial Statements

June 30, 2008

Maturities of general obligations and of revenue bonds payable, including accrued interest of capital appreciation bonds, are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2009	\$ 90,245	581,672	671,917
2010	193,880	689,052	882,932
2011	436,510	667,037	1,103,547
2012	449,994	652,809	1,102,803
2013	480,260	602,486	1,082,746
2014 – 2018	2,554,259	2,761,495	5,315,754
2019 – 2023	2,873,506	2,093,992	4,967,498
2024 – 2028	2,686,041	1,345,782	4,031,823
2029 – 2033	2,344,911	681,413	3,026,324
2034 – 2038	1,291,284	236,272	1,527,556
2039 – 2043	288,844	63,132	351,976
2044 – 2048	—	—	—
2049 – 2053	—	—	—
2054 – 2058	154,478	—	154,478
Total	13,844,212	\$ 10,375,142	24,219,354
Plus accreted discount	121,640		
Plus unamortized premium	317,206		
Less deferred charges arising from debt refunding	(291,621)		
Total	\$ 13,991,437		

### **(d) Commonwealth Appropriation Bonds**

Over the years, GDB, had extended lines of credit, advances, and loans to several agencies and component units in order to finance their capital improvement projects and to cover their operational deficits. From time to time, such financings were refunded through the issuance of Commonwealth appropriation bonds issued by the Puerto Rico Public Finance Corporation (PFC), a blended component unit of GDB. PFC is the financing arm of GDB, which serves only as a conduit for the issuance of the bonds.

During June 2004, PFC advance refunded through the PFC 2004 Series A and B and PFC 2003 Series A through C Refunding Commonwealth Appropriation Bonds, a portion of certain of its outstanding Commonwealth appropriation bonds issued in prior years (except for the Health Facilities and Services Administration bonds described below, which were not refunded). The Commonwealth recognized a mirror effect of this advance refunding by PFC in its own debt in proportion to the portion of the Commonwealth's notes included in the PFC refunding. As a result, the Commonwealth considered defeased and, therefore, removed from the balance sheet the portion refunded of \$775.7 million.

## COMMONWEALTH OF PUERTO RICO

### Notes to Basic Financial Statements

June 30, 2008

The repayment source for these bonds (both the refunding and unrefunded portions) consisted until June 30, 2006 of Commonwealth appropriations submitted for approval of the Legislature annually during the budget preparation process of the Commonwealth.

During July 2006, the source for the 2007 debt service of these appropriation bonds came from PFC instead (not from legislative appropriations), through an advance of approximately \$303 million. This advance is expected to be repaid by COFINA, a discretely presented component unit created in 2007 with the capacity to issue bonds to repay or refinance certain bonds and other debt obligations, collectively referred as the extra-constitutional debt among other purposes. The COFINA debt in turn will be serviced with the revenues generated from the collection of the first 1% of the sales and use tax, which came in effect on November 15, 2006 (note 3(c)). Recently, the Legislative Assembly of Puerto Rico expanded the purpose for which COFINA was created and, correspondingly, increased its revenue by increasing from 1% to 2.75% the portion of the sales and use tax imposed by the Commonwealth that is transferred to COFINA.

On July 31, 2007, December 20, 2007, and June 26, 2008, COFINA, a component unit of the Commonwealth, issued \$2,667 million Sales Tax Revenue Bonds Series 2007A and \$1,333 million Series 2007B, \$499.9 million Series 2007C, and \$737 million Series 2008A, respectively, to refinance certain series of the Act 164 PFC Bonds outstanding and the corresponding notes issued by PFC by certain series of the Commonwealth's agencies and component units. The Series 2007A, B, C, and 2008A proceeds were deposited in escrow with the Bank of New York/Mellon as master escrow agent.

The outstanding balance of the Commonwealth appropriation bonds comprises the following obligations (expressed in thousands):

Act No. 164 restructuring	\$ 505,423
Health Facilities and Services Administration	117,574
Office for the Improvement of Public Schools of Puerto Rico	81,367
Puerto Rico Maritime Shipping Authority (PRMSA)	99,057
Property tax settlement	<u>25,906</u>
Total Commonwealth appropriation bonds	<u>\$ 829,327</u>

On December 17, 2001, Act No. 164 was approved, which authorized certain government agencies and discretely presented component units to refund approximately \$2.4 billion of their outstanding obligations with GDB, for which no repayment source existed, over a period not exceeding 30 years, and to be repaid with annual Commonwealth appropriations not to exceed \$225 million. This refunding was done with Commonwealth appropriation bonds through several series issued by PFC during the period between December 2001 and June 2002.

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

Approximately, \$505 million of the aforementioned outstanding obligations belonged to the primary government, predominantly the Department of Health of the Commonwealth (health reform financing and other costs for approximately \$1.1 billion) and the Department of the Treasury of the Commonwealth (the fiscal year 2001 deficit financing of \$268 million and the obligation assumed for defective tax liens in the amount of approximately \$132 million). The new combined bonds balance of the Act No. 164 restructuring bears interest at rates ranging from 1.25% to 5.80%. Debt service requirements in future years are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2009	\$ —	27,313	27,313
2010	—	27,313	27,313
2011	—	27,313	27,313
2012	—	27,725	27,725
2013	—	22,488	22,488
2014 – 2018	138,710	113,360	252,070
2019 – 2023	47,823	84,923	132,746
2024 – 2028	70,164	57,900	128,064
2029 – 2032	261,796	15,922	277,718
Total	518,493	\$ 404,257	922,750
Plus unamortized premium	20,023		
Less deferred charges arising from debt refunding	(33,093)		
Total	\$ 505,423		

As of July 1, 1999, approximately \$595 million (including unpaid interest) of a promissory note of the Health Facilities and Services Administration (HFSA) due to GDB was transferred to the Department of Health of the Commonwealth and restructured through Commonwealth appropriation bonds. The bonds bear interest at rates ranging between 5.90% and 6.20%. Principal and interest on the bonds are payable solely from legislative appropriations to be made pursuant to Act No. 223 of August 9, 1998. Act 223 provides that OMB shall include in the annual budget of the Commonwealth an amount equal to \$56.5 million for the fiscal year 1998-99, and for the next succeeding 15 fiscal years, the amount necessary to pay the principal of and interest on the bonds, up to a maximum annual amount of \$57.7 million. As of June 30, 2008, approximately \$118 million was still outstanding.



**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

Debt service requirements in future years are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2009	\$ —	7,540	7,540
2010	—	7,540	7,540
2011	—	7,540	7,540
2012	—	7,540	7,540
2013	—	7,540	7,540
2014 – 2018	117,574	19,132	136,706
Total	<u>\$ 117,574</u>	<u>56,832</u>	<u>174,406</u>

Previous public schools infrastructure improvement loans provided additional funds for major repairs and improvements to the public schools in Puerto Rico. This activity is administered by the Office for the Improvement of the Public Schools of Puerto Rico (OIPS), included as part of the general fund of the primary government. These loans were refunded originally through the issuance of Commonwealth appropriation bonds pursuant to Act No. 85 of June 13, 1998 (Act 85). The new combined bonds bear interest at rates ranging from 5.00% to 5.85%. As of June 30, 2008, approximately \$81 million was outstanding.

Debt service requirements in future years are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2009	\$ —	5,096	5,096
2010	—	5,096	5,096
2011	—	5,096	5,096
2012	—	5,262	5,262
2013	6,100	3,651	9,751
2014 – 2018	—	17,660	17,660
2019 – 2023	10,060	16,326	26,386
2024 – 2028	72,465	6,461	78,926
Total	88,625	\$ <u>64,648</u>	<u>153,273</u>
Plus unamortized premium	5,392		
Less deferred charges arising from debt refunding	<u>(12,650)</u>		
Total	<u>\$ 81,367</u>		

# COMMONWEALTH OF PUERTO RICO

## Notes to Basic Financial Statements

June 30, 2008

A promissory note payable owed by PRMSA to GDB was assumed by the Commonwealth in connection with the sale of the maritime operations of PRMSA. Commonwealth appropriation bonds were issued to refund this liability. The new combined bonds balance bears interest at a variable rate ranging from 3.00% to 7.30%. Debt service requirements in future years are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2009	\$ —	5,810	5,810
2010	—	5,810	5,810
2011	—	5,810	5,810
2012	—	5,810	5,810
2013	—	5,810	5,810
2014 – 2018	66,630	20,021	86,651
2019 – 2023	27,040	7,418	34,458
2024 – 2028	13,050	3,451	16,501
2029 – 2030	7,550	216	7,766
Total	<u>114,270</u>	<u>\$ 60,156</u>	<u>174,426</u>
Less unamortized discount	(222)		
Less deferred charges arising from debt refunding	<u>(14,991)</u>		
Total	<u>\$ 99,057</u>		

During fiscal year 1996, the Commonwealth refinanced the liability for the settlement of the property taxes owed to the municipalities of Puerto Rico. Commonwealth appropriation bonds were issued to refund this liability. The new combined bonds balance bears interest at rates ranging from 5.87% to 7.25%. Debt service requirements in future years are as follows (expressed in thousands):

	<u>Principal</u>	<u>Interest</u>	<u>Total</u>
Year ending June 30:			
2013 – 2016	\$ 22,248	14,553	36,801
Total	<u>22,248</u>	<u>\$ 14,553</u>	<u>36,801</u>
Plus accreted discount	12,169		
Less deferred charges arising from debt refunding	<u>(8,511)</u>		
Total	<u>\$ 25,906</u>		

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

**(e) *Qualified Zone Academy Bonds***

During November 2001, the Department of Education of the Commonwealth issued a certification whereby certain Commonwealth public schools were designated as a “qualified zone academy” pursuant to Section 1397E of the U.S. Internal Revenue Code of 1986, as amended. On May 18, 2004, PFC, a blended component unit of GDB, issued \$47.9 million of Qualified Zone Academic Bonds (QZAB) to finance expenditures of the Department of Education of the Commonwealth under the aforementioned program, including rehabilitation and repairs of school buildings and other facilities, the development and implementation of academic curricula, technology training for some schools, and the costs of issuance of the bonds. This May 2004 QZAB is payable upon its maturity on May 2020, since the U.S. government grants tax exemptions to bond holders in lieu of an interest rate.

During January 2006, another QZAB in the amount of \$39.4 million was issued for similar purposes. The January 2006 QZAB is payable upon its maturity in January 2022. Also during January 2006, the Commonwealth unwound the 2001 defeasance of the QZAB issued in December 2001, therefore, reverting back the transaction and recognizing in the statement of net assets for the governmental activities such QZAB obligation in the amount of \$96.8 million.

During fiscal year 2008, the QZAB were refunded with proceeds coming from the July 2007 COFINA Sales Tax Revenue Bonds Series 2007A bond issuance. These proceeds were placed and are still outstanding in an irrevocable trust to provide for all future debt service payments. Accordingly, the debt has been removed and is not included in the basic financial statements. This transaction is included as a special item in the statement of activities.

**COMMONWEALTH OF PUERTO RICO**

Notes to Basic Financial Statements

June 30, 2008

*(f) Notes Payable to Component Units*

The Commonwealth has entered into various short-term line-of-credit agreements with GDB consisting of the following at June 30, 2008 (expressed in thousands):

<u>Agency</u>	<u>Purpose</u>	<u>Interest rate</u>	<u>Line of credit</u>	<u>Outstanding balance</u>
Department of the Treasury	Resources to meet appropriations in annual budget of the Commonwealth (fiscal year 2004) and federal program expenditures	125bp over three-month LIBOR	\$ 640,000	156,744
Department of the Treasury	Provide resources to meet the appropriations in the fiscal 2008 Budget	Lender's cost of funding for variable rate loans (2.48)%	113,000	113,000
Department of the Treasury	Provide resources to meet the appropriations in the fiscal 2008 Budget	Lender's cost of funding for variable rate loans (2.48)%	77,000	77,000
Department of Recreation and Sports	Recreational projects at various municipalities	150bp over GDB's commercial paper rate	16,000	1,471
Department of Transportation and Public Works	Construction and repavement of roads	150bp over GDB's commercial paper rate	15,000	5,971
			<u>\$ 861,000</u>	<u>354,186</u>